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No.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1980

JOHN NUVEEN & CO., INC., a corporation, INVESTORS SYNDICATE OF AMERICA, INC., a corporation, and INVESTORS DIVERSIFIED SERVICES, INC., a corporation

Petitioners,

v.

HENRY T. SANDERS, et al.,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

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Respondents.

QUESTIONS PRESENTED

1. Whether the "reasonable care" defense in Section 12(2) of the Securities Act of 1933 is (as construed by the court below) equivalent to, or is even more stringent than, the "reasonable investigation" defense in Section 11 of that Act, notwithstanding that (a) Congress used different, seemingly less onerous statutory language in Section 12(2) and (b) Section 12(2) applies to sales of securities generally (including sales of exempt commercial paper), whereas Section 11 applies only to the special category of registered public offerings of securities.

2. Whether, in order to exercise "reasonable care" under Section 12(2), a seller of securities must independently verify the accuracy of a certified financial statement although no such burden is imposed by Section 11.

3. Whether, in order to establish in an action under Section 12(2) that a security was sold to the plaintiff "by means of a

prospectus", plaintiff need only prove that a small number of *other* purchasers received the prospectus before making their purchases, as distinguished from proving that the plaintiff himself received the prospectus before he made his purchase.

PARTIES TO THE PROCEEDING

The defendants below are the petitioners herein, John Nuveen & Co., Inc. ("Nuveen"), Investors Syndicate of America, Inc. ("ISA") and Investors Diversified Services, Inc. ("IDS"). This action was certified as a class action on October 19, 1972. Subsequent to the entry of the District Court's initial judgment against defendants, the action proceeded on a multiple plaintiff basis, with each plaintiff participating individually, through counsel.[1]

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[1]The plaintiffs are Robert Abram; Dimmy Andrews; Harry H. Bass; Calumet-Dutch Packing Co.; Capitol Bank and Trust Co. of Springfield; Citizens State Bank of Montgomery, Minn; Jennie M. Clark; M.K. Clark & Co.; Denver National Bank; Mrs. Katherine E. Doolittle; Down East Enterprise Profit Sharing Plan; Elgin Nat'l Industries, Inc. Employees' Relief Fund; William M. Frew; Greenview Community Bank; Harbor Square Corporation, formerly Down East Enterprise, Inc.; Harmony State Bank; Hogan & Farwell, Inc.; Jackson National Life Insurance Company; Clifford M. and Eugene M. Johnson, as Trustees for Thora M. Johnson; Russell C. Kuehl; Kuehl Brothers; LaCrescent State Bank; Lawrenceville National Bank & Trust Co.; Marquette-Lake State Bank, formerly Chicago Lake State Bank; Midland Community Bank; Lawrence W. Morley; National Stock Yards National Bank; Carl T. Nelson, Jr.; Q.R.F. Corporation; Angela Raphael and Dorothea R. Coffin; Frank G. Raphael; Henry T. Sanders; S.C. Smiley & Associates; Second Boulevard Realty & Ins. Co.; Phyllis Shapiro; Elizabeth Sorenson (Effie L. Smith, Administrator); Stovall & Stovall, Inc.; Gerald R. Tapp: Trinity Grace United Methodist Church; and Freida Wallner (Ingeborg W. Smith, Executor).

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

Petitioners John Nuveen & Co., Inc., Investors Syndicate of America, Inc. and Investors Diversified Services, Inc. respectfully pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Seventh Circuit entered in this action on April 29, 1980.

OPINIONS BELOW

The Court of Appeals has rendered four opinions in separate appeals in this action. The most recent opinion ("*Sanders IV*") is officially reported at 619 F.2d 1222 and is printed in the separately bound appendix to this petition. (A. 2) The order of the Court of Appeals denying rehearing is printed in the appendix. (A. 1) The opinion of the United States District Court for the Northern District of Illinois, Eastern Division, and the orders from which that appeal was taken, not officially reported, are printed in the appendix. (A. 15, 18, 19, 20)

The first opinion of the Court of Appeals in this action is reported at 463 F.2d 1075 (7th Cir. 1972), *cert. denied*, 409 U.S. 1009 (1972) ("*Sanders I*"), and is printed in the appendix. (A. 82) The second opinion of the Court of Appeals is reported at 524 F.2d 1064 (1975) ("*Sanders II*") and is printed in the appendix. (A. 63) That decision was vacated and remanded by this Court at 425 U.S. 929 (1976). This Court's order is printed in the appendix. (A. 62) The opinion of the Court of Appeals on remand from this Court is reported at 554 F.2d 790 (1977) ("*Sanders III*") and is printed in the appendix. (A. 46)

JURISDICTION

The judgment of the United States Court of Appeals for the Seventh Circuit sought to be reviewed was entered on April 29, 1980. A timely petition for rehearing was denied on May 30, 1980. This petition for certiorari was filed within ninety days of that date. This Court's jurisdiction is invoked under 28 U.S.C. §1254(1).

STATUTES INVOLVED

Sections 11 and 12 of the Securities Act of 1933 ("1933 Act"), 15 U.S.C. §§77k and 77*l*, are set forth in the statutory appendix at the end of this petition.

STATEMENT OF THE CASE

A. The Transactions And Parties Involved

1. The Defendants-Petitioners

At all times material hereto Nuveen was a broker-dealer registered with the Securities and Exchange Commission ("SEC"). In September of 1968, Nuveen acquired the business of Ashwell & Co. ("Ashwell"), a dealer in short-term promissory notes (hereinafter referred to as "commercial paper").[2] On September 15, 1969, ISA, a wholly-owned subsidiary of IDS, acquired all of the stock of Nuveen.

2. Winter & Hirsch, Inc.

Winter & Hirsch, Inc. ("Winter & Hirsch") was one of the companies whose commercial paper was sold by Ashwell (since

[2]Commercial paper consists of unsecured, short-term promissory notes, payable to the bearer at a stated maturity, never more than 270 days. The notes are either interest-bearing notes or notes issued and sold at a discount from the face amount, which do not bear interest.

the 1930's) and later by Nuveen. Winter & Hirsch was a consumer finance company which had been in business in Chicago since 1915 and was held in very high regard by financial institutions. Winter & Hirsch obtained funds to lend from various sources, including unsecured bank loans, long-term loans, and the sale of commercial paper. As Nuveen knew, more than seventy banks, including forty Chicago-area banks, lent money to Winter & Hirsch during the period at issue in this case.[3]

3. Lieber, Bleiweis And Company

At all times material hereto, and beginning some time prior to 1960, the certified public accounting firm of Lieber, Bleiweis and Company ("Lieber, Bleiweis") and predecessors thereto purported to audit the financial statements of Winter & Hirsch on a semi-annual basis and issued opinions on those financial statements. Lieber, Bleiweis was duly licensed to practice public accounting in the State of Illinois.

Nuveen, as well as the major bank and insurance company lenders to Winter & Hirsch, all relied upon the audit reports issued by Lieber, Bleiweis. In both *Sanders II* and *Sanders IV* the Court of Appeals assumed for purposes of its decisions that, as petitioners contended, the audit reports were not defective on their face or qualified in any way and that nothing in the audit reports themselves gave Nuveen any reason to question their accuracy.[4] (*Sanders II*, A. 68-69; *Sanders IV*, A. 11 n. 10)

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[3]Eleven of the fifty largest banks on the Fortune Directory were lenders to Winter & Hirsch in this period. FORTUNE, July, 1974, p. 114.

[4]The SEC, as amicus curiae in *Sanders III*, agreed that the "audit report itself raised no necessity for further inquiry." Brief of the Securities and Exchange Commission, Amicus Curiae ("SEC Br.") at 68. Petitioners have lodged a copy of that brief with this Court.

4. The Plaintiffs-Respondents

The forty-two plaintiffs, including the named plaintiff-respondent Henry T. Sanders, purchased Winter & Hirsch commercial paper from Nuveen with an aggregate face amount of approximately $1,600,000.[5]

B. Nuveen's Investigations Of Winter & Hirsch

Prior to the first sale of Winter & Hirsch commercial paper at issue here, Nuveen made an extensive investigation of Winter & Hirsch. In December, 1968, Nuveen's experienced commercial paper credit analyst thoroughly reviewed the most recent financial statements of Winter & Hirsch, which Lieber, Bleiweis had certified. In March, 1969, the analyst spent an entire day at Winter & Hirsch meeting with its officers and making a check of its records. He sought verification, on a spot check basis, of management's statements with respect to delinquency experience and collection procedure for delinquent accounts and of the authenticity of the loans shown in the files, that is, that Winter & Hirsch had proper documentation to support the accounts receivable ledger cards. Management's statements were verified and nothing in that on-site examination disclosed any adverse information about Winter & Hirsch.

In accordance with its usual practice Nuveen made written inquiry of banks that were lenders to Winter & Hirsch. The responses to these letters raised no questions about the sound financial condition of Winter & Hirsch and were generally laudatory.

In late 1969 a subsequent financial statement of Winter & Hirsch, also certified by Lieber, Bleiweis, was reviewed by

[5]As a result of payments on behalf of Winter & Hirsch, net claims against the petitioners aggregate approximately $477,000, exclusive of pre- and post-judgment interest. Plaintiffs' attorneys have been awarded fees of $395,000 in respect of their services through the proceedings prior to *Sanders IV*, to be paid out of any amount ultimately awarded to plaintiffs. (A. 15, 17)

Nuveen. In early 1970 further inquiries were made by Nuveen of bank lenders. Again, everything appeared to be in order.

C. Discovery Of The Winter & Hirsch Fraud

In the fall of 1969 rumors about Winter & Hirsch began to reach a few of its lenders. (None of the rumors reached Nuveen.) As a result of pressure from two of these lenders, on January 9, 1970 Winter & Hirsch retained another public accounting firm, Peat, Marwick, Mitchell & Co. ("Peat, Marwick"), to conduct an audit as of January 31, 1970.

Nuveen first learned of the special audit on February 10, 1970. Despite importunings from one of Winter & Hirsch's bank lenders, Nuveen immediately ceased selling Winter & Hirsch commercial paper.

Approximately five weeks after its audit had begun, Peat, Marwick discovered a discrepancy of approximately $14,000,000 between Winter & Hirsch's actual accounts receivable and the total shown in the most recent Lieber, Bleiweis audit report. Following this discovery, all payment of Winter & Hirsch debt, including the commercial paper sold by Nuveen and owned by plaintiffs, was suspended.

It was subsequently determined that the discrepancy resulted from a fraudulent inflation of the firm's books by the management of Winter & Hirsch. This had occurred piecemeal over a period of ten years or more in collusion with Lieber, Bleiweis. Despite its certificate to the contrary, Lieber, Bleiweis had not audited Winter & Hirsch but instead had relied largely on information supplied by management. The principals of both Winter & Hirsch and Lieber, Bleiweis ultimately pleaded guilty to federal criminal fraud charges.

D. Proceedings Below And Before This Court

On March 12, 1970, Sanders filed a class action complaint against thirteen defendants, including Nuveen, IDS and ISA.[6] Sanders contended that petitioners had violated certain provisions of the federal securities laws[7] in connection with the sale by Nuveen of the commercial paper issued by Winter & Hirsch during an eight-month period beginning in June, 1969.

The District Court denied petitioners' motion contending that the short-term promissory note purchased by Sanders was not a "security" subject to the provisions of the 1934 Act. The question was certified to the Court of Appeals for the Seventh Circuit pursuant to 28 U.S.C. §1292(b). The Court of Appeals granted permission to appeal and in its first opinion, *Sanders I*, held that the note was a "security". Accordingly the court ordered a trial on the merits.[8]

Following trial the District Court found in favor of plaintiffs and against the petitioners. In its second opinion in this case, *Sanders II*, the Court of Appeals affirmed the judgment against Nuveen, ISA and IDS, holding that Nuveen had violated Rule 10b-5 by breaching its obligations as an "underwriter" of a security, that "Nuveen's investigation of [Winter & Hirsch] was deficient, and that an appropriate investigation would have

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[6]Nine defendants other than those named above were dismissed by stipulation with the approval of the District Court. In *Sanders II* the Court of Appeals reversed the District Court's judgment imposing liability on a tenth defendant, Alleghany Corporation. (A. 75)

[7]The complaint as amended to the present has asserted claims under Sections 12(1), 12(2) and 17 of the 1933 Act, 15 U.S.C. §§77*l*(1), 77*l*(2) and 77q, respectively; Sections 10(b) and 20 of the Securities Exchange Act of 1934 ("1934 Act"), 15 U.S.C. §§78j(b) and 78t, respectively; Rule 10b-5 promulgated by the SEC under the 1934 Act, 17 C.F.R. §240.10b-5; and certain of the Rules of Fair Practice of the National Association of Securities Dealers, Inc.

[8]Petitioners thereafter sought certiorari to this Court. The petition was denied. 409 U.S. 1009 (1972).

revealed the fraud." (A. 72) The decision in *Sanders II* was vacated by this Court and was remanded for reconsideration by the Court of Appeals in light of *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976). 425 U.S. 929 (1976). (A. 62)

On remand from this Court, in *Sanders III* the Court of Appeals reversed the judgment of the District Court, holding that Nuveen had not violated Rule 10b-5 because it had not acted with scienter. (A. 47-50) The Court of Appeals also refused to impose liability on several other theories urged by plaintiffs (A. 51-58), but remanded this case to the District Court so that that court could make findings and conclusions under Section 12(2) of the 1933 Act, another claimed basis for liability which had been alleged from the outset but with respect to which no findings had been made following the trial. (A. 58-60) Over defendants' objection the District Court thereafter granted plaintiffs leave to file an amendment to the complaint asserting a claim under Section 12(1) of the 1933 Act, a cause of action on which plaintiffs had previously disclaimed reliance. (A. 52, 60-61)

After an evidentiary hearing, the District Court entered a judgment holding Nuveen liable to all plaintiffs under both Sections 12(1) and 12(2).[9] (A. 20-45) In *Sanders IV* the Court of Appeals affirmed the judgment of the District Court on the ground that Nuveen was liable to the plaintiffs under Section 12(2), without reaching the Section 12(1) claim.[10] (A. 2)

BASIS FOR FEDERAL JURISDICTION

Jurisdiction of this action in the District Court was predicated upon Section 22 of the 1933 Act, 15 U.S.C. §77v.

[9]The liability of petitioners ISA and IDS is predicated solely upon their status as controlling persons of Nuveen, as determined by the Court of Appeals in *Sanders II*. (A. 73-75) No issue is presented herein as to their liability apart from the underlying liability of Nuveen.

[10]In *Sanders III*, however, when the SEC had urged Nuveen's liability under Section 12(1), the Court of Appeals expressed "great doubt" about such liability. (A. 52)

REASONS FOR GRANTING THE WRIT

Section 12(2) of the 1933 Act provides that when a security is offered or sold "by means of a prospectus or oral communication" which includes an untrue statement of material fact or omits to state a material fact necessary in order to make the statements made not misleading, the purchaser may recover from the seller. The statute exculpates the defendant, however, if he proves that "he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission." The Court of Appeals, in contravention of numerous recent decisions of this Court with respect to the proper construction of the federal securities laws, erred in holding (i) that Nuveen sold Winter & Hirsch commercial paper to all plaintiffs by means of an actionable prospectus which most of the plaintiffs never received and (ii) that Nuveen failed to establish its reasonable care defense. Review of the decision below is necessary to clarify several central elements of a claim under Section 12(2), an express civil liability provision sought to be used with increasing frequency in light of the limitations imposed by this Court on the scope of Rule 10b-5. *See, e.g., Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976).

I. THE RULING BELOW THAT THE "REASONABLE CARE" DEFENSE IN SECTION 12(2) OF THE SECURITIES ACT OF 1933 REQUIRES A MORE EXTENSIVE INVESTIGATION OF AN ISSUER OF SECURITIES THAN DOES SECTION 11 OF THAT ACT IS IN CONFLICT WITH FUNDAMENTAL PRINCIPLES UNDERLYING DECISIONS OF THIS COURT, THE POSITION OF THE SECURITIES AND EXCHANGE COMMISSION AND THE STATUTORY PATTERN OF THAT ACT.

Two principles underlie this Court's many recent decisions interpreting the federal securities laws.

First, the principal, if not exclusive, source to which a court must turn when interpreting the provisions of the federal securi-

ties laws is the words of the particular provisions themselves. *Aaron v. Securities and Exchange Commission*, 100 S.Ct. 1945, 1955 (1980); *Touche Ross & Co. v. Redington*, 442 U.S. 560, 568 (1979); *Int'l Brotherhood of Teamsters v. Daniel*, 439 U.S. 551, 558 (1979); *Santa Fe Industries v. Green*, 430 U.S. 461, 472, 477 (1977); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 200-201 (1976); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 756 (1975) (Powell, J., concurring); *Reliance Electric Co. v. Emerson Electric Co.*, 404 U.S. 418, 424, 427 (1972).

Second, and equally important, a court must read all of the express and implied civil liability provisions of the federal securities laws together to avoid anomalous results. *Touche Ross & Co. v. Redington*, 442 U.S. 560, 571-74 (1979); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 206-11 (1976); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 736 (1975). *See also Aaron v. Securities and Exchange Commission*, 100 S.Ct. 1945, 1955-57 (1980).

The Court of Appeals violated both of these principles (i) by holding that there is "no significance" to the difference in language between Sections 11 and 12(2) (A. 11), (ii) by holding that the "reasonable care" defense in Section 12(2) of the 1933 Act creates the same duties for a seller of securities as the "reasonable investigation" defense in Section 11 creates for an underwriter and (iii) by holding that liability may be imposed under Section 12(2) for the failure to conduct a more thorough investigation than would have been required under Section 11.

A. The Statutory Pattern

Section 11(a) of the 1933 Act imposes liability on certain persons, including underwriters,[11] in connection with sales of securi-

[11] In the 1933 Act the concept of an "underwriter", defined in Section 2(11), 15 U.S.C. §77b(11), has meaning only under Section 11, which refers explicitly to underwriters, and under provisions relating to the registration requirements and to liability for failure to comply therewith, namely Sections 5, 4(1) and 12(1), 15 U.S.C. §§77e, 77d(1) and 77*l*(1), respectively.

ties in a registered public offering pursuant to a registration statement which is materially false. Section 11(b) sets forth defenses for all defendants other than the issuer. In particular, an underwriter of a registered public offering is not liable if it proves:

> that (A) as regards any part of the registration statement not purporting to be made on the authority of an expert . . . [it] had, after *reasonable investigation*, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading; . . . and (C) as regards any part of the registration statement purporting to be made on the authority of an expert (other than himself) . . . [it] *had no reasonable ground to believe, and did not believe*, at the time such part of the registration statement became effective, that the statements therein were untrue or that there was an omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading. . . .

Section 11(b)(3) (emphasis added). Thus, for example, an underwriter in a registered public offering of securities is exculpated if it did not believe and had no reasonable ground to believe that an "expertised" portion of the registration statement, such as a certified financial statement,[12] was false. As to "expertised" portions, therefore, a defendant (including an underwriter) has no affirmative obligation to make any investigation.[13]

Unlike Section 11, which expressly imposes liability on particular persons, Section 12(2) applies to "[a]ny person . . . who

[12]A certified financial statement is a "statement purporting to be made on the authority of an expert" within the meaning of Section 11(b)(3)(C). Section 11(a)(4).

[13]The original Section 11(b)(3)(C) had imposed an affirmative "reasonable ground to believe and did believe" burden with regard to expertised portions. Securities Act of 1933, Pub.L. 22, §11(b)(3)(C) (1933). This was changed to the present form in 1934. Amendments to Securities Act of 1933, Pub.L. 291, §206(b) (1934).

offers or sells a security"—there is no singling out of a category of underwriters. Moreover, Section 12(2) applies to all sales of securities, whether or not made, or required to be made, pursuant to a registration statement. Liability lies under Section 12(2) unless the seller "did not know, and *in the exercise of reasonable care* could not have known, of [the] untruth or omission." (emphasis added)

B. The "Reasonable Care" Defense Of Section 12(2) Does Not Require, As The Court Of Appeals Held, A "Reasonable Investigation" Sufficient To Satisfy Section 11

In framing defenses in consecutive sections of the 1933 Act, Congress used different language in dealing with different situations: "reasonable investigation" under Section 11 in the special case of registered offerings and "reasonable care" under Section 12(2). Such distinctions in language cannot be ignored, since "[a]scertainment of congressional intent with respect to the standard of liability created by a particular section of the [1933 and 1934] Acts must . . . rest primarily on the language of that section." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 200 (1976). The distinctions in language and context between Sections 11 and 12(2) make clear that the burden of "investigation" imposed in the registration context is greater than the burden of "care" imposed in all circumstances by Section 12(2). Indeed, the very word "investigation" denotes a duty greater than mere "care".[14]

Shortly after the passage of the 1933 Act, two commentators observed that the standard under Section 12(2) is "*merely* that of 'reasonable care'." William O. Douglas and George E. Bates, "The Federal Securities Act of 1933," 41 YALE L.J. 171, 208 (1933) (footnote omitted; emphasis added). The standard of

[14] *Compare* this Court's analysis of the ordinary meaning of the words used in Rule 10b-5 (*Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197-200 (1976)) and in Section 17(a) of the 1933 Act (*Aaron v. Securities and Exchange Commission*, 100 S.Ct. 1945, 1955 and n. 13 (1980)).

reasonableness under Section 12(2) "presumably is somewhat less exacting" than under Section 11. *Id.*, at n. 205. In its amicus brief in *Sanders III* the SEC stated that the Section 11 and Section 12(2) defenses are not the same and vigorously opposed imposing Section 11 investigation burdens on a Section 12(2) seller. (SEC Br. 69-71, 74; *see also* pp. 14-15, *infra*). *See also Lanza v. Drexel & Co.*, 479 F.2d 1277, 1309 (2d Cir. 1973) (refusing to impose Section 11 standards applicable to directors in an action under Rule 10b-5).

The court below completely ignored the patent distinction between these two sections in summarily "find[ing] no significance in this difference in language in the case at bar." (A. 11) The court merely adopted the analysis in *Sanders II*, where it had held, relying almost exclusively on Section 11 precedents, that Nuveen had breached its duty as an underwriter of commercial paper.[15] (*Sanders II*, A. 68-73; *Sanders IV*, A. 11-13) "[T]he *reasonable care* standard required the *reasonable investigation* described in *Sanders II*." (*Sanders IV*, A. 13) (emphasis added).

C. The Court Of Appeals Imposed A Greater Burden Under Section 12(2) Than Under Section 11, Thereby Completely Ignoring The Statutory Pattern Of The Securities Act of 1933

Not only did the court below erroneously rely upon Section 11 precedents to delineate the "reasonable care" standard of Section 12(2), but it actually imposed a burden greater than that which exists under Section 11.

In the context of a registered public offering Section 11(b)(3)(C) explicitly exonerates a defendant sued in connection with a false certified financial statement in the registration statement where the defendant merely "had no reasonable ground to

[15] In *Sanders II* the Court of Appeals was considering Nuveen's liability under Rule 10b-5. Section 12(2) was not addressed at all. (A. 68)

believe and did not believe" that the financial statement was misleading. *See Escott v. BarChris Construction Corp.*, 283 F.Supp. 643, 697 (S.D.N.Y. 1968) (underwriter held liable as to some portions of the registration statement but not as to the false certified financial statements). *See also* 3 Loss, *Securities Regulation* 1726-27 (2d ed. 1961).

In *Sanders IV*, as it had done in *Sanders II*, the Court of Appeals assumed that the Lieber, Bleiweis audit reports "on their face, gave Nuveen no reason to question their accuracy."[16] (*Sanders IV*, A. 11 n. 10; *Sanders II*, A. 68-69) The Court of Appeals also held that Nuveen had an "honest belief that the financial statements [of Winter & Hirsch] prepared by certified public accountants correctly represented [its] financial condition." (*Sanders II*, A. 63, quoted in *Sanders IV*, A. 5). Therefore, if the instant claims had arisen in connection with a registration statement Nuveen would have been exonerated under Section 11(b)(3)(C). The Court of Appeals held, however, that Nuveen failed to exercise reasonable care because it did not investigate the accountants' workpapers, and that Nuveen should have "determin[ed] the basic integrity of the issuer's financial statements." (*Sanders II*, A. 72, followed in *Sanders IV*, A. 10-13)

In imposing a duty of verification of an accountant's report in these circumstances, the decision below thus set a standard of care greater than that imposed by Section 11 and *a fortiori* far beyond that applicable to a seller under Section 12(2). (As discussed in the next section of this petition, the SEC shares this criticism.) Requiring an underwriter or other seller to go behind a certified financial statement is unprecedented.

> [A]bsent actual knowledge or warning signals, a broker-dealer should not be under a duty to retain his own auditor to

[16]The District Court held that the audit reports raised questions on their face. (A. 41-42) However, throughout the Court of Appeals has assumed that these findings were in error, and in its amicus brief in *Sanders III* the SEC expressed concurrence with that view of the evidence. (SEC Br. 15 n. 26, 68)

> re-examine the books of every company, the stock of which he may offer for sale, even accepting the doubtful hypothesis that such permission would be granted.

Levine v. Securities and Exchange Commission, 436 F.2d 88, 90 (2d Cir. 1971).

It would be anomalous and contrary to the decisional rationale of *Ernst & Ernst v. Hochfelder*, 425 U.S. at 210, to hold a defendant liable under Section 12(2) for relying on an unqualified auditors' report when the immediately preceding section of the same statute—on its face imposing a more severe test ("reasonable investigation" rather than "reasonable care")—expressly provides that such reliance is not negligent. *See also Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 752-54 (1975).

D. In Its Amicus Brief In *Sanders III* And In A General Analysis Of The Commercial Paper Market The SEC Has Concluded That An Underwriter Of Unregistered Commercial Paper Need Not Conduct A Section 11 "Reasonable Investigation," Particularly With Respect To Certified Financial Statements

In its amicus brief filed with the court below in *Sanders III* the SEC was expressly critical of the *Sanders II* ruling which held Nuveen liable for failing to verify the accuracy of the Lieber, Bleiweis audit report. The requirement to review accountants' workpapers "could prove too strict and too rigid." (SEC Br. 68) The SEC continued:

> We believe that it would be inconsistent with the statutory scheme to apply precisely the same standards to the scope of an underwriter's duty under Section 12(2) as the case law appropriately has applied to underwriters under Section 11. . . . Since Congress has determined that registration is not necessary in certain defined situations, we believe that it would undermine Congressional intent—that issuers and

> other persons should be relieved of the burden of registration—if the same degree of investigation were to be required to avoid potential liability whether or not a registration statement is required.

SEC Br. 69. *See also* SEC Br. 70-71.[17]

The SEC has elsewhere pointed out that the type of inquiry made by a commercial paper dealer is not as exhaustive as the investigation mandated by Section 11 in connection with registered offerings:

> [T]here is no investigation undertaken by the [commercial paper] dealer which would even approximate that which is required of an underwriter of a security offering registered with the Commission pursuant to the 1933 Act.[18]

In making the foregoing statement, which was written after the events at issue in this case, the SEC did not suggest that these practices by a dealer were unlawful.

E. The Ruling Below May Have A Significant Dampening Effect On The Commercial Paper Market

There are substantial practical considerations which support the distinction between Sections 11 and 12(2) established by

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[17]In *Sanders III* the SEC took the position that if the Winter & Hirsch commercial paper was exempt from registration Nuveen had met its burden of reasonable care. (SEC Br. 54, 74, 76) The SEC also contended, contrary to petitioners' position, that the standard of reasonable care is higher when the securities are not exempt, that the Winter & Hirsch commercial paper was not exempt (*but see* p. 7, n. 10, *supra*) and that Nuveen had failed to meet the higher standard of reasonable care purportedly applicable in those circumstances. (SEC Br. 60-61, 76)

[18]Staff Report of the Securities and Exchange Commission to the Special Subcommittee on Investigations, "The Financial Collapse of the Penn Central Company" 273-74 (1972).

Congress. The obliteration of this distinction by the court below may have a significant dampening effect on a very important element of this country's credit markets.[19]

Commercial paper is used by businesses with fluctuating cash needs and is sold on a recurring basis, as needed, to meet the issuer's current requirements for short-term financing. Under Section 12(2), liability is determined as of the date of each sale. This is to be contrasted with an underwriter's liability under Section 11, which is determined as of the effective date of the registration statement. Folk, "Civil Liabilities under the Federal Securities Acts: The *BarChris* Case," 55 VA.L.REV. 199, 263 (1969). Thus while a seller of unregistered commercial paper has a continuing obligation to exercise "reasonable care" as regards facts communicated by it about the issuer, the underwriter of a registered offering need make only a single "investigation".

If Section 11 investigation burdens were imposed so that a commercial paper dealer were obligated to conduct a continuous full scale "due diligence" investigation typical in registered public offerings, it would eliminate from commercial paper markets those issuers that could not afford to pay the increased commission or spread necessary to compensate the dealer for undertaking

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[19]As of April 30, 1980, the amount of commercial paper outstanding in the United States exceeded 120 billion dollars, of which over 18 billion dollars had been sold by dealers. 66 FEDERAL RESERVE BULLETIN, June, 1980, at A25. Early in 1980, when interest rates on long-term debt soared, commercial paper became an increasingly important source of funds. "With interest rates on long-term bonds at an all-time high, senior financial officers of the nation's major companies are seeking alternative sources of funds by turning to stock offerings, short-term borrowings from major banks, commercial paper and foreign banks." New York Times, March 3, 1980, page D1. *See also* "New Era for Banking," BUSINESS WEEK, April 21, 1980, page 92 (commercial paper provided a critical source of financing in the Spring, 1980 credit crunch).

that kind of perpetual investigation.[20] The SEC shared this concern as amicus in *Sanders III*:

> If a very heavy burden of investigation into the creditworthiness of each issuer were to be placed upon commercial paper dealers going considerably beyond the reliance on audit reports for assessment of short-term prospects, the spontaneity of the market would probably be impeded and the expenses of detailed investigations might raise costs considerably. Indeed, to require an underwriter of unregistered commercial paper to examine all of the corporate minutes, schedules of delinquencies, correspondence with creditors and customers, financing agreements, inventories, and the like, would impose such an onerous burden upon them as conceivably to make impracticable the market for such securities.

SEC Br. 70-71.

If the correct interpretation of "reasonable care" had been applied in this case, Nuveen would not have been held liable. *See* SEC Br. 73-76. Nuveen's exercise of reasonable care was thwarted by the deliberate, collusive fraud of the issuer and its independent accountant. The record established that Nuveen's efforts exceeded prevailing industry standards. Nuveen thoroughly examined the certified financial statements of Winter & Hirsch, interviewed the issuer's officers, reviewed delinquency and other original records of the issuer and communicated with the issuer's lenders. No more should have been required in these circumstances.

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[20]The commercial paper dealer typically collects a commission of one-eighth or one-quarter of a percentage point. Staff Report of the Securities and Exchange Commission to the Special Subcommittee on Investigations, "The Financial Collapse of the Penn Central Company" 274 (1972). (Nuveen made a gross profit of $65.02 on Sanders' purchase of $34,245.31, or 0.19%.) The underwriting spread in large, higher grade public offerings of equity securities is 6½% to 8%. Robinson and Eppler, GOING PUBLIC §6, p. 13 (1978 Revision).

II. THE COURT BELOW REPLACED THE ELEMENT OF CAUSATION UNDER SECTION 12(2) WITH AN IRREBUTTABLE PRESUMPTION. THIS SUBSTANTIALLY BROADENED SECTION 12(2) IN A MANNER INCONSISTENT WITH THIS COURT'S MANDATE THAT EACH PROVISION OF THE FEDERAL SECURITIES LAWS BE INTERPRETED CONSISTENTLY WITH ITS OWN LANGUAGE AND THE STATUTORY PATTERN

A seller is liable under Section 12(2) if it sells securities "by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in light of the circumstances under which they were made, not misleading." The Court of Appeals held that Nuveen sold the commercial paper to every one of the forty-two plaintiffs "by means of" a false prospectus,[21] even though nearly all of the purchasers had never seen or even been aware of the prospectus. The ruling was based on a presumption which Congress apparently rejected in enacting Section 12(2); and in applying such a presumption the ruling expanded Section 12(2) to parallel Section 11 without, however, affording the defendant any of the carefully drafted safeguards included in Section 11. Once again, the Court of Appeals was able to accomplish such a result only by improperly ignoring the statutory pattern established by the express civil liability provisions of the 1933 Act.

A. The Ruling Below

Petitioners contended that only if a purchaser-plaintiff had received the defendant-seller's report on Winter & Hirsch com-

[21]The concept of "prospectus" for purposes of Section 12(2) is broader than the prospectus required in registered offerings. *Compare* Sections 2(10) and 10 of the 1933 Act, 15 U.S.C. §§77b(10) and 77j, respectively. There is no dispute that the Nuveen commercial paper reports on Winter & Hirsch were prospectuses in the broad sense for purposes of Section 12(2). Since those reports reproduced the certified financial statements of Winter & Hirsch—which, unbeknownst to Nuveen, were not accurate—the reports were false in part.

mercial paper prior to purchasing the commercial paper could the sale have been effected "by means of" the report. The evidence established that only three of the forty-two plaintiffs had received a Nuveen report on Winter & Hirsch before they made their purchases. The Court of Appeals held, however, that all plaintiffs could recover.

> Although the statute explicitly requires privity between plaintiff-purchaser and defendant-seller, its terms do not require that the particular sale to an individual plaintiff be directly by means of the prospectus alleged to be misleading.
>
> . . . .
>
> . . . [I]t is enough that the seller sold by means of a misleading prospectus securities of which those purchased by the plaintiff were a part.

(A. 8-9) (footnotes omitted). The rationale of the decision was that the reports created a market for the commercial paper, at least to the extent that the interest rate was determined by the information Nuveen made available about the issuer. (A. 9) "The misleading reports were instrumental to the sales at bar through their effect on the market." (A. 9 n. 7) Further, the court reasoned, if the commercial paper report had disclosed the truth, the market for this commercial paper would have collapsed. (A. 9)

The court below, however, expressly acknowledged the weakness of its own approach when it stated that

> the result might be different if only oral communications were involved. That statute's reference to an oral communication by means of which a security is sold arguably suggests a statement made to the individual buyer of the security.

(A. 9-10 n. 8) If the oral communication must be direct and personal, then so must be the use of the prospectus, because the statute makes no distinction between the two types of communication. The same language ("by means of") cannot have differing

meanings depending upon whether the communication was written or oral. *Cf. Aaron v. Securities and Exchange Commission*, 100 S. Ct. 1945, 1952 (1980) (Rule 10b-5 means the same thing "regardless of the plaintiff or the nature of the relief sought.")

B. Congress Included A Rebuttable Presumption Of Market Impact In Section 11; No Such Presumption Was Included In, Or Should Be Applied In Actions Under, Section 12(2)

The Court of Appeals' rationale for affirming the judgment under Section 12(2) in favor of all plaintiffs, even though only three had received a prospectus before purchasing, was a market impact theory. The sole authority cited for the application of that theory in an action under Section 12(2) was a passage from the House Report on the bill which became the 1933 Act. (A. 8) While this passage ostensibly refers to both Sections 11 and 12, the discussion in the House Report is clearly focused upon registration statements, *i.e.*, upon Section 11. H.R. Rep. No. 85, 73d Cong., 1st Sess. 9-10 (1933). For example, the quoted section of the House Report begins, "Sections 11 and 12 . . . entitle the buyer of securities sold upon a *registration statement* . . . to sue for recovery of his purchase price. . . ." *Id.*, at 9 (emphasis added). The subject of this passage is further clarified by reference to a later, more detailed discussion of Section 11, which refers to security values "affected by the information given in the registration statement" and to granting a remedy to "all purchasers who may reasonably be affected by any statements in the registration statement." H.R. Rep. No. 85, 73d Cong., 1st Sess. 22 (1933). These market impact concepts are not mentioned anywhere in the detailed analysis of Section 12(2) also contained in that report. *Id.*, at 23. Likewise, the language quoted by the Court of Appeals refers to "wide dissemination" (A. 8), a situation which obtains where a registration statement is used, but not necessarily in the Section 12(2) context and certainly not here. Thus, the material

relied upon by the court below delineated the rationale of the structure of Section 11, and has no application to Section 12(2).

A comparison of the context and language of Sections 11 and 12(2) also demonstrates that the market impact theory is reflected in Section 11 alone, giving rise to a compelling inference that no such presumption—let alone an irrebuttable one—should be applied in actions under Section 12(2). Registration statements are in fact *required* to be widely disseminated, particularly during and after an initial public offering. *See* Sections 4(3) and 5 of the 1933 Act, 15 U.S.C. §§77d(3) and 77e; 1 Loss, SECURITIES REGULATION 257-58 (2d ed. 1961); 4 Loss, SECURITIES REGULATION 2327-30 (1969 Supp.). In that context it was reasonable for Congress to presume that the market price of a security would be affected by the registration statement. Accordingly, Congress chose not to impose a burden on a plaintiff to prove causation in an action under Section 11. The buyer need only prove that he purchased a security issued pursuant to the registration statement. *Barnes v. Osofsky*, 373 F.2d 269 (2d Cir. 1967).[22] However, even in this context Congress made the presumption rebuttable by granting a causation defense. Section 11(e) provides that the plaintiff may not recover damages that represent "other than the depreciation in value of such security resulting from [the defective] part of the registration statement".[23] This permits a defendant to show, in effect, that the faulty registration statement did not inflate the market price of the security, by proving that after the sale to plaintiff the market price of the security declined for

[22]One may *not* sue under Section 11, however, as to securities of the same class as those covered by the registration statement but which were not sold pursuant to that registration statement. *Barnes v. Osofsky*, 373 F.2d 269 (2d Cir. 1967). Thus, the scope of Section 11 and of the market impact presumption were strictly limited by Congress.

[23]This defense was added in 1934. Amendments to Securities Act of 1933, Pub. L. 291, §206(d) (1934). At the same time, Congress added a reliance requirement under certain circumstances. *Id.*, §206(a), codified in Section 11(a), 15 U.S.C. §77k(a). No similar changes were made in Section 12(2).

reasons other than disclosure of the facts omitted from or misrepresented in the registration statement. *See, e.g., Feit v. Leasco Data Processing Equipment Corp.*, 332 F.Supp. 544, 586 (E.D.N.Y. 1971).

While it was reasonable to create a rebuttable presumption that a registration statement would have market impact, Congress had no basis to indulge in such a blanket presumption in drafting Section 12(2), since that section applies to *any* "prospectus or oral communication," without regard to any legal requirement or fact of wide dissemination. Since Congress included no such presumption, it imposed an affirmative burden of proof of causation in the form of the "by means of" requirement. It is, therefore, singularly inappropriate for a court to supply by interpretation a presumption under Section 12(2), but that is precisely what the Court of Appeals did here.

The fact that the court below applied a presumption is established by the absence of any meaningful analysis of the record by it. There were no findings demonstrating that the market was *in fact* either created or sustained by Nuveen's few reports. Winter & Hirsch commercial paper had been sold for decades before Nuveen began to sell it less than a year before the first purchase at issue here. The market could just as well have been sustained by inertia, by Winter & Hirsch's established credit standing with major Chicago and other banks, by word of mouth not emanating from Nuveen, by dissemination by others of the Lieber, Bleiweis audit reports themselves, by the reports on Winter & Hirsch disseminated by the National Credit Office (a commercial paper rating agency), or by a combination of those and other factors. Finally, the Court of Appeals did not take into account that many sales at issue in this case preceded distribution of the three commercial paper reports received by plaintiffs, so that the reports relied upon by the court below could but have created or sustained the "market" in which the early purchases occurred. The court improperly presumed market impact.

Moreover, the presumption as applied by the Court of Appeals was virtually irrebuttable. Under the Court of Appeals' theory, a single document sent to a single purchaser among numerous claimants would satisfy the "by means of" requirement for all claimants since (by hypothesis) disclosure of the truth in that single document would have destroyed a market which (by hypothesis) was sustained by the single report. Nothing in the court's analysis permits line-drawing to determine how much dissemination is enough—in the instant case three, or perhaps one,[24] of forty-two was enough. Thus, the Court of Appeals applied an irrebuttable presumption where Congress rejected even a rebuttable one.[25]

C. The Decision Below Is Inconsistent With Decisions Of Other Courts Construing Section 12(2)

This market impact interpretation of Section 12(2) is not only at odds with the statutory pattern but, not surprisingly, is inconsistent with prior readings of Section 12(2). For example, this Court has described Section 12(2) as establishing a cause of action against the seller "with respect to prospectuses and communication *to* 'the person purchasing such security from him.' " *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 728 (1975)

[24]The court below held that Nuveen could be held liable under Section 12(2) "without reference to the evidence adduced at the [post-*Sanders III*] evidentiary hearing." (A. 3 n. 2) Yet prior to that hearing only one plaintiff had proved receipt of a commercial paper report, and it was later established that he did not actually see the report until three weeks after his purchase.

[25]This Court has often condemned the use of presumptions as a substitute for more searching inquiry. *See, e.g., Vlandis v. Kline*, 412 U.S. 441, 446, 452 (1973) (it is unfair to employ a "permanent and irrebuttable presumption . . . [which] is not necessarily or universally true in fact" where there are "reasonable alternative means of making the crucial determination"); *Cleveland Bd. of Education v. La Fleur*, 414 U.S. 632, 644-45 (1974). While no constitutional claim is made here, the principles underlying this Court's skepticism about irrebuttable presumptions serve equally well here, particularly in light of the statutory pattern discussed in the text.

(emphasis added). This description is in accordance with the plain meaning of Section 12(2), *i.e.*, that the challenged communication must be made directly to the plaintiff.

Other federal courts, relying on the plain meaning of Section 12(2), have held that the plaintiff must *prove* causation, as described above, in order to sustain a cause of action. In *Lorber v. Beebe*, 407 F.Supp. 279 (S.D.N.Y. 1976), the plaintiff purchased securities two weeks after commencement of a public offering which, of course, entailed wide dissemination of the prospectus. On the Section 12(2) claim the District Court granted summary judgment to plaintiff's seller, one of the underwriters of the public offering, on the ground that the seller did not supply plaintiff with a prospectus and so the sale had not been "by means of" the prospectus. 407 F.Supp. at 295-96. The decision below is squarely in conflict with *Lorber*.

Similarly, in *Jackson v. Oppenheim*, 533 F.2d 826 (2d Cir. 1976), the court held, "[T]he communication must have been intended or perceived as instrumental in effecting the sale." 533 F.2d at 830 n. 8. A plaintiff who never received the commercial paper report could not have "perceived" it as anything. If Nuveen did not send a report to that plaintiff it could not have been "intended" to effect that sale. *See also Mason v. Marshall*, 412 F.Supp. 294, 301 (N.D.Tex. 1974) (alternative holding), *aff'd per curiam*, 531 F.2d 1274 (5th Cir. 1976), where the District Court held that where the prospectus was received after the plaintiff had communicated to the buyer his decision to buy there was no basis for liability under Section 12(2).

D. The Decision Below, Especially When Coupled With Other Recent, Questionable Interpretations of Section 12(2), Threatens To Destroy The Statutory Pattern Of The 1933 Act.

The virtual elimination of the "by means of" element of the cause of action under Section 12(2) is particularly troublesome if

it is applied in conjunction with the growing line of cases which, erroneously in petitioners' view, eliminate the statutory privity requirement in actions under Section 12(2).[26] These concurrent developments effectively grant a cause of action to purchasers with only the most remote contact with the seller, since neither direct communication nor strict privity is required. This further contravenes the carefully formulated pattern established by Congress.

Congress enacted various safeguards where there is no privity requirement. Section 11 has no privity requirement, but significantly limits the total damages which can be assessed. For example, an underwriter cannot be held liable "for damages in excess of the total price at which the securities underwritten *by him* and distributed to the public were offered to the public." Section 11(e)[27] (emphasis added). Presumably Congress did not insert such protections into Section 12(2) because they were thought to be superfluous; Section 12(2) required both privity and direct dealing between plaintiff and defendant. The judicial rejection of those two limitations without a corresponding implemen-

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[26] *See, e.g., Hill York Corp. v. American Int'l Franchises, Inc.*, 448 F.2d 680, 695 (5th Cir. 1971); *Vogel v. Trahan*, FED.SEC.L.REP. (CCH) ¶97,303, at pp. 97,082-83 (E.D. Pa. 1980) [1979-80 Transfer Binder]; *Stern v. American Bankshares Corp.*, 429 F.Supp. 818, 824 (E.D. Wis. 1977); *Sandusky Land, Ltd. v. Uniplan Groups*, 400 F.Supp. 440, 444 (N.D. Ohio 1975); *In re Caesars Palace Securities Litigation*, 360 F.Supp. 366, 378-83 (S.D.N.Y. 1973), imposing Section 12(2) liability on mere participants in and aiders and abettors of the sale. *But see*, requiring strict privity, *Collins v. Signetics Corp.*, 605 F.2d 110, 113 (3d Cir. 1979); *McFarland v. Memorex Corp.*, FED.SEC.L.REP. (CCH) ¶97,368, at pp. 97,461-62 (N.D. Cal. 1980) [1979-80 Transfer Binder]. According to the court below, Section 12(2) requires privity between buyer and seller. (A. 8, 14) However, the Court of Appeals paid that "requirement" lip service at best, since it denied rehearing when defendants demonstrated that there were at least two intermediaries between Nuveen and four of the plaintiffs.

[27] The cited portion of Section 11(e) was added in 1934. Amendments to Securities Act of 1933, Pub. L. 291, §206(e) (1934).

tation of restrictions such as those contained in Section 11(e) patently destroys the statutory pattern.[28] *See, e.g., In re Gap Stores Securities Litigation*, 79 F.R.D. 283, 307 (N.D.Cal. 1978) (if Section 12(2) does not require privity, the Section 12(2) liability of an underwriter of a public offering could improperly exceed the damage limitations imposed by Section 11(e)). A market impact theory may be viable under Rule 10b-5 in the absence of privity. *See, e.g., Blackie v. Barrack*, 524 F.2d 891, 907 (9th Cir. 1975), *cert. denied*, 429 U.S. 816 (1976). But such extensive liability under Rule 10b-5 may be sustained only if scienter is proven — a far more appropriate standard in such circumstances than the reasonable care defense as construed by the court below.

The decision below transforms Section 12(2) into a cause of action for engaging in a negligent course of business, not unlike many pre-*Hochfelder* interpretations of Rule 10b-5(c). Yet the very essence of this Court's ruling in *Hochfelder* was to prevent the use of Rule 10b-5 as the basis for a cause of action for negligence without the explicit limitations found in the express liability provisions, such as Section 12(2). 425 U.S. at 207-11. The court below has now removed those very limitations from Section 12(2) itself!

SUMMARY

The decision below—alleviating plaintiff's burden of proof, expanding the class of plaintiffs and increasing substantially a defendant's burden of reasonable care—destroys the carefully

[28]Consider the following comparison. If Nuveen had been but one of several dealers in Winter & Hirsch commercial paper, under petitioners' reading of Section 12(2) Nuveen's liability, if any, would have been to those to whom it made statements actionable under Section 12(2) and with whom it was in privity. Under the market impact presumption applied below, however, Nuveen's liability could extend to all of the customers of the other dealers as well, even though Nuveen's reports never reached them and they were not in privity with Nuveen. Still more draconian, in order to sustain the reasonable care defense Nuveen would have to show that it virtually retraced the steps of the issuer's independent accountant.

wrought interrelationship of Sections 11 and 12(2) and of all of the implied and express civil liability provisions, which this Court delineated in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), and *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975). In particular, the decision below ignores, or actually reverses, distinctions between two sections of the same statute obviously related to the fact that one (Section 11) applies only to registered public offerings whereas the other (Section 12(2)) applies to all sales of securities, including commercial paper (as in the instant case) and other exempt securities. To paraphrase this Court's statement in *Touche Ross & Co. v. Redington*, 442 U.S. 560, 578 (1979), quoting *Securities and Exchange Commission v. Sloan*, 436 U.S. 103, 116 (1978), generalized references to the remedial purposes of the 1933 Act "will not justify reading a provision 'more broadly than its language and the statutory scheme reasonably permit.'"

CONCLUSION

For the reasons given, petitioners pray that a writ be granted to review the judgment and opinion below.

Respectfully submitted,

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STATUTORY APPENDIX

Section 11 of the Securities Act of 1933, 15 U.S.C. §77k

(a) In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security (unless it is proved that at the time of such acquisition he knew of such untruth or omission) may, either at law or in equity, in any court of competent jurisdiction, sue—

(1) every person who signed the registration statement;

(2) every person who was a director of (or person performing similar functions) or partner in, the issuer at the time of the filing of the part of the registration statement with respect to which his liability is asserted;

(3) every person who, with his consent, is named in the registration statement as being or about to become a director, person performing similar functions, or partner;

(4) every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement, with respect to the statement in such registration statement, report, or valuation, which purports to have been prepared or certified by him;

(5) every underwriter with respect to such security.

If such person acquired the security after the issuer has made generally available to its security holders an earning statement covering a period of at least twelve months beginning after the effective date of the registration statement, then the right of recovery under this subsection shall be conditioned on proof that such person acquired the security relying upon such untrue statement in the registration statement or relying upon the registration statement and not knowing

of such omission, but such reliance may be established without proof of the reading of the registration statement by such person.

(b) Notwithstanding the provisions of subsection (a) no person, other than the issuer, shall be liable as provided therein who shall sustain the burden of proof—

(1) that before the effective date of the part of the registration statement with respect to which his liability is asserted (A) he had resigned from or had taken such steps as are permitted by law to resign from, or ceased or refused to act in, every office, capacity, or relationship in which he was described in the registration statement as acting or agreeing to act, and (B) he had advised the Commission and the issuer in writing that he had taken such action and that he would not be responsible for such part of the registration statement; or

(2) that if such part of the registration statement became effective without his knowledge, upon becoming aware of such fact he forthwith acted and advised the Commission, in accordance with paragraph (1) of this subsection, and, in addition, gave reasonable public notice that such part of the registration statement had become effective without his knowledge; or

(3) that (A) as regards any part of the registration statement not purporting to be made on the authority of an expert, and not purporting to be a copy of or extract from a report or valuation of an expert, and not purporting to be made on the authority of a public official document or statement, he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading; and (B) as regards any part of the registration statement purporting to be made upon his authority as an expert or purporting to be a copy of or extract from a report or valuation of himself as an expert, (i) be had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the

registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, or (ii) such part of the registration statement did not fairly represent his statement as an expert or was not a fair copy of or extract from his report or valuation as an expert; and (C) as regards any part of the registration statement purporting to be made on the authority of an expert (other than himself) or purporting to be a copy of or extract from a report or valuation of an expert (other than himself), he had no reasonable ground to believe, and did not believe, at the time such part of the registration statement became effective, that the statements therein were untrue or that there was an omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, or that such part of the registration statement did not fairly represent the statement of the expert or was not a fair copy of or extract from the report or valuation of the expert; and (D) as regards any part of the registration statement purporting to be a statement made by an official person or purporting to be a copy of or extract from a public official document, he had no reasonable ground to believe and did not believe, at the time such part of the registration statement became effective, that the statements therein were untrue, or that there was an omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, or that such part of the registration statement did not fairly represent the statement made by the official person or was not a fair copy of or extract from the public official document.

(c) In determining, for the purpose of paragraph (3) of subsection (b) of this section, what constitutes reasonable investigation and reasonable ground for belief, the standard of reasonableness shall be that required of a prudent man in the management of his own property.

(d) If any person becomes an underwriter with respect to the security after the part of the registration statement with respect

to which his liability is asserted has become effective, then for the purposes of paragraph (3) of subsection (b) of this section such part of the registration statement shall be considered as having become effective with respect to such person as of the time when he became an underwriter.

(e) The suit authorized under subsection (a) of this section may be to recover such damages as shall represent the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and (1) the value thereof as of the time such suit was brought, or (2) the price at which such security shall have been disposed of in the market before suit, or (3) the price at which such security shall have been disposed of after suit but before judgment if such damages shall be less than the damages representing the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and the value thereof as of the time such suit was brought: *Provided*, That if the defendant proves that any portion or all of such damages represents other than the depreciation in value of such security resulting from such part of the registration statement, with respect to which his liability is asserted, not being true or omitting to state a material fact required to be stated therein or necessary to make the statements therein not misleading, such portion of or all such damages shall not be recoverable. In no event shall any underwriter (unless such underwriter shall have knowingly received from the issuer for acting as an underwriter some benefit, directly or indirectly, in which all other underwriters similarly situated did not share in proportion to their respective interests in the underwriting) be liable in any suit or as a consequence of suits authorized under subsection (a) for damages in excess of the total price at which the securities underwritten by him and distributed to the public were offered to the public. In any suit under this or any other section of this title the court may, in its discretion, require an undertaking for the payment of the costs of such suit, including

reasonable attorney's fees, and if judgment shall be rendered against a party litigant, upon the motion of the other party litigant, such costs may be assessed in favor of such party litigant (whether or not such undertaking has been required) if the court believes the suit or the defense to have been without merit, in an amount sufficient to reimburse him for the reasonable expenses incurred by him, in connection with such suit, such costs to be taxed in the manner usually provided for taxing of costs in the court in which the suit was heard.

(f) All or any one or more of the persons specified in subsection (a) shall be jointly and severally liable, and every person who becomes liable to make any payment under this section may recover contribution as in cases of contract from any person who, if sued separately, would have been liable to make the same payment, unless the person who has become liable was, and the other was not, guilty of fraudulent misrepresentation.

(g) In no case shall the amount recoverable under this section exceed the price at which the security was offered to the public.

Section 12 the Securities Act of 1933, 15 U.S.C. §771

Any person who—

(1) offers or sells a security in violation of section 5, or

(2) offers or sells a security (whether or not exempted by the provisions of section 3, other than paragraph (2) of subsection (a) thereof), by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of

reasonable care could not have known, of such untruth or omission,

shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

Supreme Court, U. S.
FILED
AUG 27 1980
MICHAEL RODAK, JR., CLERK

80-299

No.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1980

JOHN NUVEEN & CO., INC., a corporation, INVESTORS SYNDICATE OF AMERICA, INC., a corporation, and INVESTORS DIVERSIFIED SERVICES, INC., a corporation,

Petitioners,

vs.

HENRY T. SANDERS, et al.,

Respondents.

APPENDIX TO PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

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UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT
CHICAGO, ILLINOIS 60604

MAY 30, 1980

BEFORE

HON. HARLINGTON WOOD, JR., Circuit Judge
HON. EDWARD DUMBAULD, Senior District Judge*

HENRY T. SANDERS, et al., *Plaintiffs-Appellees,* v. JOHN NUVEEN & CO., INC., INVESTORS DIVERSIFIED SERVICES, INC. and INVESTORS SYNDICATE OF AMERICA, INC., *Defendants-Appellants.*	Nos. 79-1192, 79-1248 and 79-1657 Appeal from the United States District Court for the Northern District of Illinois Eastern Division No. 70-C 597 J. Sam Perry, *Judge*

ORDER

On consideration of the petition for rehearing filed in the above-entitled cause by counsel for the defendants-appellants, Judges Wood and Dumbauld, members of the original panel, have voted to deny rehearing.** Accordingly,

IT IS HEREBY ORDERED that the aforesaid petition for rehearing be, and the same is hereby, DENIED.

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*The Honorable Edward Dumbauld, Senior District Judge of the United States District Court for the Western District of Pennsylvania, is sitting by designation.

**Judge Philip W. Tone sat on the original panel but resigned prior to consideration of the petition for rehearing.

HENRY T. SANDERS, et al.,
Plaintiff-Appellees,

v.

JOHN NUVEEN & CO., INC., INVESTORS DIVERSIFIED SERVICES, INC. and INVESTORS SYNDICATE OF AMERICA, INC.,
Defendants-Appellants.

Nos. 79-1192, 79-1248 and 79-1657.

United States Court of Appeals,
Seventh Circuit.

Argued Nov. 5, 1979.
Decided April 29, 1980.
Rehearing Denied May 30, 1980.

Before TONE and WOOD, Circuit Judges, and DUMBAULD, Senior District Judge.*

TONE, Circuit Judge.

The issue we decide on this appeal is whether plaintiff class members have established their claims under §12(2) of the Securities Act of 1933, 15 U.S.C. §77*l*(2). Holding that they have, we affirm the district court's judgment in their favor.

The case has been here three times previously. 463 F.2d 1075 (7th Cir.), *cert. denied*, 409 U.S. 1009, 93 S.Ct. 443, 34 L.Ed.2d 302 (1972) (*Sanders I*); 524 F.2d 1064 (7th Cir. 1975), *vacated and remanded*, 425 U.S. 929, 96 S.Ct. 1659, 48 L.Ed.2d 172 (1976) (*Sanders II*); 554 F.2d 790 (7th Cir. 1977) (*Sanders III*). It is enough at this point to say that our affirmance in *Sanders II*

*The Honorable Edward Dumbauld, Senior District Judge of the United States District Court for the Western District of Pennsylvania is sitting by designation.

of the judgment in plaintiffs' favor based on §10(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j(b), was rendered untenable by the holding of the Supreme Court in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 96 S.Ct. 1375, 47 L.Ed.2d 668 (1976), that scienter is an element of a private cause of action under §10(b); and that in *Sanders III* we therefore remanded the case to the district court primarily for a determination of plaintiffs' claims under §12(2) of the 1933 Act.[1] On remand that court held an evidentiary hearing[2] and then made additional findings in favor of plaintiffs and entered judgment accordingly.

The background facts having been stated in detail in *Sanders II* and revisited in *Sanders III*, we shall do no more here than summarize those facts that are now material.

Plaintiff class consists of forty-two purchasers of unsecured short-term promissory notes aggregating $1,612,500 issued by Winter & Hirsch, Inc. (WH), a consumer finance company. The purchases were made from John Nuveen & Co., Inc. during a seven-month period immediately preceding WH's default on the

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[1]We left it to the discretion of the district court whether to allow amendment to add allegations of violation of §12(1) of the 1933 Act. *See* 554 F.2d at 798-99. That court allowed amendment and decided the §12(1) issue in favor of the plaintiff class. Because §12(1) is merely an alternate ground of recovery and we hold in favor of the class on the §12(2) issue, we do not reach the §12(1) issue. For the same reason we need not rule on defendants' argument that the district court abused its discretion on remand in allowing plaintiffs to amend the complaint to allege violation of §12(1).

[2]Defendants argue that inasmuch as the §12(2) claim was before the district court in May 1974, when the case was tried, plaintiffs should have offered at that time all their evidence in support of that claim and should not have been permitted to offer further evidence in the proceedings upon remand after *Sanders III*. We are not unsympathetic to this argument, but we cannot say the district court abused its discretion in conducting a supplemental evidentiary hearing. Moreover, in our view of the case, the judgment should be sustained without reference to the evidence adduced at the supplemental evidentiary hearing.

notes in February 1970. The defendants other than Nuveen are corporations found to be controlling persons of Nuveen.

Nuveen was the exclusive underwriter of the WH notes, which were sold, like other commercial paper, through its branch offices throughout the United States. As the underwriter, it bought the notes from WH and resold them to customers at a profit. According to the head of Nuveen's commercial paper department, Nuveen sold commercial paper, including the notes of WH, on the basis "that there should be no question but what the paper will be paid at maturity."

Nuveen prepared and circulated to prospective customers "commercial paper reports" on the WH commercial paper that it held for sale. Three members of the plaintiff class testified to having received copies of these reports before they bought WH notes. Two other members testified to having received commercial paper reports, but could not swear to having received them before making their purchases. Nine class members, including the three who had received reports before purchasing, testified that, when they bought their WH notes, Nuveen salesmen made oral statements about the quality of the notes. There was no evidence of oral communications to any other class members. All class members received the usual written confirmations advising them that they had purchased certain described notes and that Nuveen had sold the notes as principal.

WH's default was the product of a fraud it perpetrated with the connivance of the certified public accountants who audited its financial statements and rendered opinions thereon. In summary, over a period of ten years WH continually issued financial statements in which accounts receivable were overstated and some of its indebtedness was omitted. By 1970 WH's financial statements overstated accounts receivable by some $14,000,000 and failed to reflect some $1,750,000 of indebtedness. When the notes in issue

in this case were purchased by members of the plaintiff class, WH's liabilities exceeded its assets.

Nuveen was not aware of the fraud and held "the mistaken but honest belief that financial statements [of WH] prepared by certified public accountants correctly represented the condition of" WH. 524 F.2d at 1066. It accordingly proceeded to sell the WH notes and also to issue commercial paper reports thereon that reflected the false WH financial statements.

Sanders II held that Nuveen failed to make a reasonable investigation, which it was the duty of an underwriter to make under §10(b) of the 1934 Act, and that such an investigation "would have revealed the fraud." *Id.* at 1071.

After WH had dishonored the notes sold to the plaintiff class members, it was taken over by its creditors. They established the WH Liquidating Trust, liquidated WH, and over a period of time distributed the proceeds of the liquidation to creditors, including members of the plaintiff class, who received through these distributions approximately two-thirds of the amounts they paid Nuveen for the notes. The judgment appealed from is for the unpaid balance of the purchase price of the notes.

I.

Defendant's first argument is that recovery by thirty-three of the forty-two class members is defeated by the absence of evidence of receipt by them of "a prospectus or oral communication" meeting the requirements of §12(2). That section imposes liability on

> [a]ny person who . . . [o]ffers or sells a security . . . by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in light of the circumstances under which they were made, not misleading. . . .

Liability is in favor of "the person purchasing such security from" the person who offers or sells the security. The purchaser must not have known of the untruth or omission.

Plaintiffs contend that several kinds of communications satisfied the prospectus or oral communication requirement of the statute. We need consider only one, the commercial paper reports.[3]

Defendants admit that the reports were prospectuses and that they were false and misleading. The reports repeated the false financial information contained in the WH financial statements. Also, they stated that the figures were from a detailed audit when in fact the auditors' opinions stated that no detailed audit had been made.

Defendants' only response to this argument is that, except as to the three members proved to have received copies of reports

[3]In addition to the commercial paper reports, plaintiffs rely upon oral statements made by Nuveen salesmen in offering the notes, the confirmations of sales sent by Nuveen to all purchasers after the sales had been agreed upon, and implied representations, by Nuveen that it had conducted an ongoing investigation of WH's financial condition and found WH to be creditworthy. The testimony shows oral statements as to only nine members of the class. As to the others, plaintiffs rely on an answer to an interrogatory, but the defendants argue that the answer is not before the court. We need not resolve that dispute. The confirmations are included in the definition of prospectuses in §2(10), 15 U.S.C. §77b(10), but by their nature convey no information about the merit of the security, and it may therefore reasonably be questioned whether they contain misrepresentations or suffer from omissions that meet the statutory test. Two circuits have upheld §12(2) liability based on false implied representations. *Alton Box Board Co. v. Goldman, Sachs & Co.*, 560 F.2d 916, 922-23 (8th Cir. 1977); *Franklin Savings Bank v. Levy*, 551 F.2d 521, 527 (2d Cir. 1977); but in both cases the sufficiency of implied, as distinguished from express, misrepresentations was conceded. It is to be noted that the statute imposes liability for "a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact." (Emphasis supplied.) We express no opinion on the issue suggested by this footnote.

before their purchases, the reports had no "causal relationship" with the sales of the WH notes.

Although the "by means of" language in the statute requires some causal connection between the misleading representation or omission and plaintiff's purchase, defendants' interpretation of that standard is much too stringent. It is well settled that §12(2) imposes liability without regard to whether the buyer relied on the misrepresentation or omission. *Hill York Corp. v. American International Franchises, Inc.*, 448 F.2d 680, 696 (5th Cir. 1971); *Gilbert v. Nixon*, 429 F.2d 348, 356–57 (10th Cir. 1970); *Johns Hopkins University v. Hutton*, 422 F.2d 1124, 1129–30 (4th Cir. 1970). *See* Kaminsky, *An Analysis of Securities Litigation Under Section 12(2) and How It Compares with Rule 10b-5*, 13 Hous. L.Rev. 231, 258, 265 (1976). To require a plaintiff to have received a commercial paper report before purchasing, as defendants would have us do, would tend toward erroneously imposing a reliance requirement.[4]

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[4]In *Demarco v. Edens*, 390 F.2d 836 (2d Cir. 1968), the court rejected in dictum the argument that recovery could not be had under §12(2) because the "offering circulars" in question were not received by the buyers until after the confirmations of sales had been received. The court reasoned that such a requirement would introduce an element of reliance not mandated by the statute.

However, one could require proof of receipt of a misleading prospectus or oral communication to show not that the buyer relied on the information in deciding to purchase, but that the vendor sold the security to the individual plaintiff "by means of" the misleading communication. Indeed, in Demarco the defendants specifically disclaimed a reliance argument before the district court, contending instead that since the prospectus was in no way employed in the transaction, they had not sold to plaintiffs "by means of" the prospectus. Nevertheless, the district court found liability appropriate essentially as an ancillary enforcement mechanism for the SEC regulation requiring that, with respect to some securities exempted from registration, the offering circular be sent before the confirmation. *Demarco v. Edens*, [1966–67 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶91,856, at 95924, 95933–34 (S.D.N.Y. Dec. 13, 1966).

The statutory language, as amplified by the legislative history, indicates that a plaintiff need not prove that he ever received the misleading prospectus. The statute imposes liability in favor of a purchaser on any person who "[o]ffers or sells a security . . . by means of a prospectus or oral communication" that is misleading. Although the statute explicitly requires privity between plaintiff-purchaser and defendant-seller,[5] its terms do not require that the particular sale to an individual plaintiff be directly by means of the prospectus alleged to be misleading. The causal connection contemplated by the statute is revealed in the House Report on the bill that, after changes not relevant here, became the Securities Act of 1933. *See generally* Landis, *The Legislative History of the Securities Act of 1933*, 28 Geo. Wash.L. Rev. 29 (1959). Referring to §§11 and 12, the two sections imposing civil liabilities, the report declared that statements issued in connection with the sale of securities,

> although they may never actually have been seen by the prospective purchaser, because of their wide dissemination, determine the market price of the security which in the last analysis reflects those manifold causes that are the impelling motive of the particular purchase. The connection between the statements made and the purchase of the security is clear, and, for this reason, it is the essence of fairness to insist upon the assumption of responsibility for the making of these statements.

H.R.Rep.No. 85, 73d Cong., 1st Sess. 10 (1933),[6] *reprinted at* 2 *Legislative History of the Securities Act of 1933 and Securities*

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[5]Section 12(2) states that a seller is liable to "the person purchasing such security from him."

[6]It is to be noted that the first portion of the paragraph of which the quoted passage is the second portion is a discussion of the constitutionality of imposing civil liability for actions of an intrastate character, a question presumably not relevant to §12(2) because of that subsection's express requirement of use of interstate mails, transportation, or communications. Although appearing in the same paragraph, the portion quoted is not relevant to the constitutional question and, like other passages in the report jointly treating §§11 and 12, seems intended to enunciate policies underlying both sections of the Act.

Exchange Act of 1934, Item 18 (J. Ellenberger & E. Mahar, compilers, 1973) [hereinafter cited as *Legislative History*].

Defendants argue that this is not "an open market trading case where dissemination of information to some buyers or sellers can have an impact upon the market price and thus affect transactions by people who never saw the documents." The attempted distinction lacks substance. Even though short term commercial paper is not ordinarily traded in the same way as stock and instruments of indebtedness of publicly held companies, the price it will bring depends upon the financial condition of the issuer relative to that of other issuers and the going interest rates in the money market. In that sense there is a market price. A prospectus that reports on the issuer's financial condition affects that price. In the case at bar, publication of WH's true financial condition would have caused a total collapse of the market for its notes.[7]

Thus, it is enough that the seller sold by means of a misleading prospectus securities of which those purchased by the plaintiff were a part.[8] The false and misleading WH commercial paper

[7] *Jackson v. Oppenheim*, 533 F.2d 826, 829–30 (2d Cir. 1976) which is cited by defendants, does not conflict with our holding. In that case an outside director of a corporation sued an inside director under §12(2) for omitting certain facts from an oral communication. The discussion relied on by plaintiff, in which defendant tried to persuade plaintiff of the firm's mismanagement, occurred in the context of the inside director attempting not to sell his stock to plaintiff, but to gain plaintiff's support for changes in management. After defendant continued his efforts to effect a change in management, plaintiff, along with others apparently loyal to current management, approached defendant with an offer to buy him out, an offer that defendant accepted. The court held that defendant did not sell his stock "by means of" his prior conversation since it was "neither intended nor perceived as instrumental in effecting the sale." In the case at bar, Nuveen issued its commercial paper reports on WH as part of its effort to sell WH notes. The misleading reports were instrumental to the sales at bar through their effect on the market.

[8] Although the statutory language is the same with respect to misleading prospectuses and oral communications, the result might be different

(Footnote continued on next page)

reports issued by Nuveen therefore satisfy the statute's requirement of a false or misleading prospectus "by means of" which the security was sold, regardless of whether all plaintiff class members received copies of those reports.

II.

Defendants also argue that they have established a defense under §12(2) by sustaining their burden of proving that they "in the exercise of reasonable care could not have known" of the claimed untruth or omission. This argument is in essence a reargument of issues decided by the opinion of Mr. Justice (then Judge) Stevens in his opinion in *Sanders II*.

Proceeding on the assumption that scienter, whether in its willful or reckless form,[9] was not an essential element of a §10(b) claim, *Sanders II* upheld the district court's determination that Nuveen had "breached a duty to make reasonable inquiries that would have led to the discovery of the issuer's fraud." 524 F.2d at 1066. In determining what Nuveen could reasonably have been expected to do, that opinion noted that Nuveen's status as underwriter was significant even though neither §10(b) nor Rule 10b-5 expressly imposed a greater burden on underwriters. For instance, in response to Nuveen's argument that it needed only to discover and to disclose those facts that were "reasonably ascertainable," the standard generally applicable to broker-dealers, the court declared that,

> a greater quantity of information is "reasonably ascertainable" by an underwriter than by a mere broker, and

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(Continued from previous page)
if only oral communications were involved. That statute's reference to an oral communication by means of which a security is sold arguably suggests a statement made to the individual buyer of the security. Spoken words lack continuing vitality and are unlikely to affect the general market price of a security. We are dealing here, however, with writings, *i.e.*, prospectuses.

[9] *See Sanders III*, 554 F.2d at 792–93.

> something more than published data must be analyzed if an underwriter is to discharge his duty of investigation. In this case, the district court correctly found that Nuveen's investigation of WH was deficient and that an appropriate investigation would have revealed the fraud.

Id. at 1071. The court also took into account two arguments Nuveen repeats here—that it needed to make a lesser investigation because WH notes were short term commercial paper and not stock or long term indebtedness, and that its reliance on the credit lines extended by various banks to WH was reasonable.[10] The court concluded that Nuveen was "under a duty to make at least some investigation directed at the question whether the ever present possibility of fraud is in fact a reality," and that Nuveen had breached that duty. *Id.* at 1071.

We find no reason to distinguish between the duty of reasonable care in the implied cause of action for negligence that was assumed to exist under §10(b) in *Sanders II* and the duty of reasonable care expressly imposed by §12(2) of the 1933 Act. Defendants attempt to distinguish *Sanders II* on the ground that while this court relied heavily in that case on decisions construing §11, which explicitly requires a "reasonable investigation," §12(2) requires only that defendants show exercise of "reasonable care." We find no significance in this difference in language in the case at bar.

It is not at all clear that Congress intended to impose a higher standard of care under §11 than under §12(2).[11] The difference in

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[10]The *Sanders II* court assumed, as do we, that the audit reports of WH's independent accountant, on their face, gave Nuveen no reason to question their accuracy. 524 F.2d at 1069.

[11]We also note that the phrase "reasonable investigation" is not a prerequisite for imposition of that standard of care; the phrase relied upon does not appear in §10(b) either, yet the *Sanders II* court found the authorities under §11 apt.

language appeared in the House bill and was retained in the Act as agreed to by the Joint Conference Committee and as passed by both Houses. *See* H.R. 5480, 3d Cong., 1st Sess. §§11 & 12 (1933), *reprinted at* 1 *Legislative History*, *supra*, Item 1 (bill as passed by both Houses), *and* 3 *Id.*, Items 25 & 26 (bill as presented to House by its Committee on Interstate and Foreign Commerce and as originally passed by House). The Conference Committee report, in its discussion of the standard of liability imposed for a misleading registration statement, described the standard adopted not as one of "reasonable investigation," but one of "reasonable care." H.R. Rep.No.152, 73d Cong., 1st Sess. 26 (1933)(Conference Report), *reprinted at* 2 *Legislative History*, *supra*, Item 19. More specifically, Congress does not appear to have intended that a different standard apply to underwriters. Thus, the House Report draws no distinction between an underwriter's burden in the case of misleading statements in a prospectus, for which it can be liable only under §12(2), and its §11 duty to conduct a "reasonable investigation." H.R.Rep.No.85, 73d Cong., 1st Sess.9 (1933), *reprinted at* 2 *Legislative History*, *supra*, Item 18. The difference in language can be explained not as an attempt to impose different duties of care under §§11 and 12, but by the fact that §12(2) imposes the duty on all sellers of securities, while §11 imposes liability only on specified groups of persons having such a close relationship with the registration statement that the 1933 Act, before it was amended the following year, treated them as fiduciaries. *See* Securities Act of 1933, ch. 38, §11(c), 48 Stat. 74, 83 (1933); Securities Exchange Act of 1934, ch. 404, §206(c), 48 Stat. 881, 907 (1934). Thus the general duty of reasonable care, the specific requirements of which are determined by the circumstances of the case,[12] was to be applied in §11 only to persons who had a stronger connection with a

[12]The fact that §12(2) does not expressly single out underwriters, as defined in §2(11), 15 U.S.C. §77b(11), for a higher standard of liability does not mean that this status is irrelevant to determining what specific actions Nuveen need show to prove its exercise of reasonable care.

registration statement than a seller necessarily has to a prospectus, so a more stringent articulation of the standard was appropriate.

In the circumstances of this case, the reasonable care standard required the reasonable investigation described in *Sanders II*.[13] Since what constitutes reasonable care under §12(2) depends upon the circumstances, we, of course, do not intimate that the duty of a seller under §12(2) is always the same as that of an underwriter in a registration offering under §11.

III.

Defendants argue in a footnote of their brief that plaintiffs failed to prove they did not know of the untruth or omission. In this case, however, it is fair to presume from the fact that a plaintiff purchased the notes that he did not know the issuer was hopelessly insolvent, a fact that would have been disclosed by accurate figures. Earlier in this case, Nuveen contended specifically that at least one of the forty-two plaintiffs, National Stock Yards National Bank, knew of the fraud before purchasing. That contention was disposed of in *Sanders II*. 524 F.2d at 1074.

Defendants argue in another footnote that the duty of reasonable care it owed its bank customers was not as great as the duty it owed to individuals, because banks were more sophisticated and had greater access to information about WH than individual customers. Section 12(2) does not establish a graduated scale of duty depending upon the sophistication and access to information of the customer. *Hill York Corp. v. American International Franchises, Inc.*, 448 F.2d 680, 696 5th Cir. (1971). A plaintiff under §12(2) is not required to prove due diligence. *See, e.g., Gilbert v. Nixon*, 429 F.2d 348, 356 (10th Cir. 1970). All that is required is ignorance of the untruth or omission.

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[13]In reaching this conclusion, we have taken into account the fact that these securities were not registered.

IV.

In still another footnote argument, defendants invoke the rule that a purchaser can recover under §12(2) only from his immediate seller. *See* note 5 *supra*. *Hill York Corp. v. American International Franchises, Inc.*, *supra*, 448 F.2d at 692 & n. 17, 695 & n. 24. They say this rule bars the claims of "several plaintiffs" whom they do not identify but who they assert "purchased from third parties." That assertion is supported only by a reference to an exhibit in the record that consists of a large stack of Nuveen confirmations reciting the sale of WH Notes by Nuveen to various purchasers. Plaintiffs' brief ignores this footnote argument. Lacking any further guidance, we are unable to determine the basis for the assertion that several plaintiffs purchased from third parties or to say that the contrary finding implicit in the district court's judgment is erroneous.

AFFIRMED.

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

HENRY T. SANDERS, et al.,
Plaintiffs,

v.

JOHN NUVEEN & CO., INC., et al.,
Defendants.

No. 70 C 597

ORDER

This matter coming on to be heard on the Petition of Class Counsel For an Award of Attorneys' Fees and Reimbursement of Expenses, and for assessment against defendants of a portion of the fees, costs and expenses incurred in this action, due notice of the hearing held on May 18, 1979 having been given each member of the class pursuant to the order of this Court entered April 6, 1979, no member of the class having filed an objection to the said Petition, the Court having considered the petition of Class Counsel, the Response of Defendants, the Memorandum of Plaintiffs In Support of Assessment of Fees And Costs Against Defendants, and Defendants' memorandum in response thereto, and having heard oral argument by the attorneys for plaintiffs and defendants, finds as follows.

1. The attorneys for the plaintiffs have devoted in excess of 3,564.4 hours to the prosecution of this case on behalf of the named plaintiff and the members of the plaintiff class.

2. Application of plaintiffs' attorneys' usual and customary charges for non-contingent legal matters during the eight years this litigation has been pending to the services rendered by them in this case, would result in an average rate of $73.90 per hour. Plaintiffs' attorneys have been retained by plaintiff on a contingent basis and designated as counsel

for the class. Plaintiffs' attorneys have not been paid any fees for the services they have rendered in this matter.

3. Due to the complexity of this litigation, the numerous appeals in which plaintiffs' attorneys have been required to participate, the professional manner and skill with which said attorneys have conducted this litigation, the skill and tenacity of defendants' counsel, the benefits conferred upon the class by the efforts of the attorneys for plaintiffs, and the contingent nature of their representation, plaintiffs' counsel are entitled to be compensated at the average rate of $110.85 per hour, being a multiple of one and one-half times the rates customarily charged by plaintiffs' counsel for non-contingent litigation.

4. All counsel who have rendered services in this matter on behalf of plaintiffs were or are partners in, or were or are employed by the law firms of Frankel, McKay, Orlikoff and Denten and its predecessors, and Orlikoff, Tierney and Peters, Chartered and its predecessor. Said firms merged on January 1, 1976. Class counsel Richard Orlikoff and Robert J. Peters are partners in the firm of Frankel, McKay, Orlikoff and Denten, and have represented to this Court that they are authorized to petition this Court for an award of fees for all services rendered in the matter by all attorneys appearing for or in behalf of plaintiffs.

5. Plaintiffs' counsel have incurred necessary expenses in the sum of $10,311.95 in prosecuting this litigation.

6. Plaintiffs have filed with the Court a Bill of Costs in the total amount of $6,092.84, to which Bill of Costs defendants have objected.

7. The defendants have not presented any frivolous defenses to plaintiffs' claims, nor have the defendants acted in bad faith before this Court in this matter.

It Is Therefore Ordered, Adjudged and Decreed as follows:

1. The Court hereby allows and awards to Richard Orlikoff and Robert J. Peters, class counsel, as fees for and on account of the services rendered herein by all attorneys for the plaintiff class through March 5, 1979, the sum of

$394,990.50, and the sum of $10,311.95 in reimbursement of expenses incurred by attorneys for plaintiffs in this matter, said sums to be paid and disbursed from funds collected from the defendants and paid into this Court in satisfaction of the judgment for plaintiffs entered herein. The claim of each plaintiff shall be charged with the amount which is the same percentage of this award of fees and expenses as the claim of that plaintiff bears to the total amount of the plaintiffs' claims approved in this action.

2. The Petition of plaintiffs for assessment against defendants of a portion of the fees and expenses awarded to plaintiffs' counsel is hereby denied.

3. When the costs to be assessed against defendants have been determined and paid by defendants, said costs shall be allocated to plaintiffs in the same percentage of said sum that the claim of each plaintiff bears to the total of plaintiffs' claims approved in this action.

Dated: May 31, 1979 ENTER:

/s/ J. Perry

Judge
United States District Court

Approved as to form:

One of the attorneys for the plaintiff class

One of the attorneys for defendants

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

HENRY T. SANDERS, et al.,
Plaintiffs,

v.

JOHN NUVEEN & CO., INC., et al.,
Defendants.

No. 70 C 597

ORDER APPROVING CLASS CLAIMS

Pursuant to the Judgment Order entered herein on January 10, 1979, as modified January 15, 1979, plaintiffs have filed with the Court and served upon defendants Plaintiffs' Itemization Of Principal And Interest Due To Be Paid Each Member Of The Plaintiff Class, and defendants have acknowledged, without prejudice to their rights to contest said Judgment Order in all respects other than the correctness of the computation of class claims, that the claims as itemized are correct.

THEREFORE, IT IS ORDERED that the claims of the class, as set forth in the schedule annexed hereto as Exhibit A, be and hereby are approved.

Dated: February 23, 1979

ENTER:

/s/ J. PERRY
District Judge

APPROVED:

Class Counsel

Counsel for Defendants

[Exhibit omitted]

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

HENRY T. SANDERS, et al.,
Plaintiffs,

v.

JOHN NUVEEN & CO., INC., et al.,
Defendants.

No. 70 C 597

ORDER

Our motion of plaintiffs to amend the judgment entered herein on January 10, 1979, the parties having appeared in open Court, and the Court being duly advised in the premises, it is

Ordered that the Judgment Order entered herein on January 10, 1979 is amended hereby by deleting from paragraph 1, page 34 thereof the words and figures, "seven per cent (7%)" and substituting therefor the words and figures, "eight per cent (8%)."

Dated: January 15, 1979

ENTER:

/s/ J. PERRY

J. Sam Perry
Judge, United States
District Court

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

HENRY T. SANDERS, et al.,
Plaintiffs,

v.

JOHN NUVEEN & CO., INC., et al.,
Defendants.

No. 70 C 597

JUDGMENT ORDER
FINDINGS OF FACT AND CONCLUSIONS OF LAW

This action coming on for further proceedings before this Court in accordance with the Opinion of the United States Court of Appeals for the Seventh Circuit rendered herein on April 22, 1977, as modified on Denial of Rehearing En Banc, June 8, 1977, 554 F.2d 790, and this Court having conducted further proceedings; and

This action having been established as a class action under Rule 23, Federal Rules of Civil Procedure, 28 U.S.C., by order of this Court dated October 19, 1972, and notice sufficient to bind those of the class who did not elect to be excluded having been sent to each member of the class, one person electing to be excluded;

This court makes the following Findings of Fact, Conclusions of Law and Judgment:

FINDINGS OF FACT

Plaintiff

1. Plaintiff brought this action as an individual and class action on behalf of purchasers of notes issued by Winter & Hirsch, Inc.

("WH") and sold by John Nuveen & Co., Inc. ("Nuveen"), asserting claims under and pursuant to the Securities Exchange Act of 1934 (15 U.S.C. §78a *et seq.*), and Rule 10b-5 promulgated thereunder, 17 C.F.R. §240.10b-5, the Securities Act of 1933 (15 U.S.C. §77a *et seq.*) and the Rules of Fair Practices of the National Association of Securities Dealers. (Complaint, ¶1; Amended Complaint, ¶3.) This action was not brought collusively to confer jurisdiction which this Court would not otherwise have.

2. Plaintiff Henry T. Sanders, on January 29, 1970, purchased from Nuveen for his own account a note issued by WH in a face amount of $35,000.00, for which plaintiff paid $34,245.31. (Stip. ¶19; PX 82 (1); Tr. 134.) Plaintiff Sanders purchased the WH Note from Nuveen with funds realized from the sale of a tax-exempt bond. Nuveen purchased the WH note for Sanders as a holding device so that interest would be earned on the funds until a longer-term investment suitable for his investment purposes became available. (Tr. 117–20.)

Defendants

3. At all times material hereto Nuveen was engaged in the business of underwriting and distributing to investors, brokers and other dealers commercial paper, corporation bonds and stocks, U.S. Government securities, Federal Agency obligations, municipal bonds and tax exempt notes, except that Nuveen ceased selling corporation stocks in July, 1969. Nuveen also was the sponsor-underwriter of the Nuveen Tax Exempt Bond Fund, which is a series of closed-end registered investment trusts, the assets of which are invested in a diversified group of issues of municipal bonds. The Company maintained secondary market positions from time to time with respect to all of the above-named investment media. (Stip. ¶5; PX 6.)

4. In September, 1968, Nuveen acquired the assets and business of Ashwell & Company, a commercial paper broker, and

Nuveen commenced to underwrite and sell commercial paper. (Tr. 225.) Prior to September, 1968, Nuveen had never handled or sold commercial paper. (Tr. 240, 341.)

5. On September 15, 1969, Investors Syndicate of America, Inc. acquired all the issued and outstanding voting stock of Nuveen. At all times material and relevant hereto Investors Diversified Services, Inc. ("IDS") was the sole stockholder of Investors Syndicate of America, Inc. IDS was and is engaged in the business of mutual fund underwriting and as an investment adviser. (Stip. ¶6; PX 1, 2.)

6. Following the acquisition of all the outstanding stock of Nuveen, IDS caused its senior vice-president, Kenneth Wahlberg, to become a member of the board of directors of Nuveen, and a member of a three-man executive committee established to conduct and supervise Nuveen's operations. Wahlberg was experienced in buying commercial paper. Richard Franke, the executive vice-president of Nuveen, testified that Nuveen looked to Wahlberg for expert guidance and direction in conducting Nuveen's commercial paper operations. (Tr. 200–1.) In December, 1969, Nuveen's executive committee reviewed the commercial paper sold by Nuveen and made the decision that Nuveen would continue to sell the notes issued by WH. (Tr. 539–41.)

Winter & Hirsch, Inc.

7. The principal business of WH was financing the purchase of automobiles by members of the general public on both a discount and direct loan basis. Its business also included the financing of inventory of automobile dealers and direct consumer loans for various purposes. (Stip. ¶1.)

8. For the years ended August 31, 1968 and August 31, 1969, and for the six (6) month period ended February 28, 1969, WH issued financial statements purportedly audited by the certified

public accounting firm of Lieber, Bleiweis and Company ("LB"), which statements were not in fact audited by LB or by any other firm of certified public accountants (Tr. 428), and which statements falsely, erroneously and inaccurately presented the financial condition of WH. (Stip. ¶¶2, 39, 41, 44, 55, 58; JX 1, 2, 3; PX 21, 26.)

9. The business of a finance company such as WH is loaning money. WH obtained funds to loan from the following sources: capital invested by common and preferred stockholders; money loaned by banks in the form of unsecured bank lines of credit; long-term loans; subordinated loans from institutional lenders, such as insurance companies; and the sale of commercial paper. WH attempted to make a profit by lending funds out at a higher rate of interest than WH had to pay for its funds, either in the form of dividends or interest. The majority of the assets of WH were its accounts receivable and its liabilities were in the form of short-term and long-term senior debt, subordinated debt and short-term notes generally in the form of commercial paper. (Stip. ¶3.)

10. The commercial paper of WH consisted of unsecured promissory notes payable to the bearer at a stated maturity of less than 270 days. WH issued these notes at a discount, without interest.

11. On November 10, 1969, J. Russell Hanson, an officer of the First National Bank of Chicago, a lender to WH, received an anonymous telephone call in which the caller informed Hanson that the "WH statements were not right." Hanson telephoned officers of other lenders and discovered that William Zeh of the Lincoln National Life Insurance Co. and Floyd Smith of Mutual of New York had heard similar rumors. After numerous discussions with officers of other financial institutions, and with Milton Hirsch, President of WH, and with Bleiweis of LB, and after a

preliminary examination of WH by an investigator named Tom McGinn, who was retained by Lincoln National Life Insurance Co., various lenders to and creditors of WH prevailed upon WH to retain the certified accounting firm of Peat Marwick and Mitchell ("PMM") to do a full audit of WH. PMM was so retained on January 12, 1970. (Stip. ¶¶24 through 33.)

12. On January 11, 1970 Bernard Wiczer, an attorney for WH, told Hanson that Yale Izaks, executive vice-president of WH, had stated that the books of WH had been manipulated and that two other officers of WH were implicated. Yale Izaks left the employ of WH on January 11, 1970. (Stip. ¶¶30, 35.)

13. Auditors and agents employed by PMM to audit WH discovered the following:

(a) On January 14, 1970 it was determined that WH had not filed a federal income tax return for the year ended 8/31/69, and had not obtained an extension of time for filing the return. (Stip. ¶37; PX 23.)

(b) On January 15, 1970 it was discovered that the work papers on which the 8/31/69 financial statements were prepared were not available; the journal for year-end adjustments was not available; and the general ledger of WH could not be reconciled to the 8/31/69 statement of net worth in the WH financial statements. (Stip. ¶38.)

(c) On January 19, 1970 PMM discovered that WH had not been able to prepare the 11/30/69 quarterly financial statement required by WH long-term debt agreements. (Stip. ¶38; PX 22.)

(d) On January 23, 1970 PMM discovered that the work papers for LB for their 8/31/69 audit of WH were virtually non-existent, and that LB had not audited WH in recent years. (Stip. ¶39; Tr. 428.)

14. In auditing WH, PMM found the following:

(a) WH had experienced in excess of ten years of misstated financial statements and manipulations. (Stip. ¶41; PX 26.)

(b) WH had not balanced its receivables to its ledgers. WH listed its receivable accounts every six months, but the sheets were merely turned over to Yale Izaks and were never seen again. (Stip. ¶42; PX 27.)

(c) There was a discrepancy of $14 million between the actual WH accounts receivable and the WH ledgers. Since at least 1961 WH had increased the amount of receivables shown on its control ledgers and financial statements over the amount of WH's actual receivables. (Stip. ¶55.)

(d) Bank loans totalling $1,750,000 had not been entered on the WH books. This discrepancy was traced back to the audit date of 8/31/69. (Stip. ¶55.)

(e) Prior to February 6, 1970, WH had not filed its federal income tax return for its fiscal year ended August 31, 1969, and had not obtained an extension of time in which to file said return. That application for an extension of time was filed by PMM between February 6 and 13, 1970. (Stip. ¶¶46 through 48.)

(f) LB made no audit or write-up on WH internal control procedures. LB had no work papers used to reconcile the receivables trial balance to the general ledger control accounts. LB had allowed WH personnel to control the selection of WH accounts receivable to be confirmed. (Stip. ¶39.)

15. On February 25, 1970, the president of WH telegraphed all its lenders and advised them that WH was suspending all payments on its debt. (Stip. ¶56.)

16. At the time WH ceased paying its debts there were outstanding 56 short term notes issued by WH and sold by Nuveen, totalling $1,661,500 in face value, and these notes were held by 44 different firms or individuals. (PX 59.) One of the notes was held by Nuveen. The other 43 holders are members of the plaintiff class and were given notice of this action. One class member has opted out, and 42 members remain in the class, holding a total of $1,612,500 par or face value of WH short-term notes. (PX 59, 66.) Each such WH note was sold by Nuveen during the period 6/30/69 to 2/10/70. (PX 37.)

17. As of September 30, 1970 the creditors of WH established a Liquidating Trust with Chicago Title & Trust Company as Trustee. The purpose of the Liquidating Trust was to collect all the assets of WH, and to distribute those assets to the creditors under a formula set forth in the Liquidating Trust. (Stip. ¶66; PX 92.)

18. All WH lenders were requested to execute a Consent Agreement relative to the establishment of the trust. An Advisory Committee to the Liquidating Trust was established. The Liquidating Trust, with the advice and consent of the Advisory Committee, was given the task of converting the assets of WH to cash and providing for distribution to the creditors on at least a semi-annual basis. (Stip. ¶67.)

19. Nuveen solicited consents to the WH liquidating Trust from the holders of WH commercial paper upon the representation that such consent would not constitute a waiver of any rights the holders of WH commercial paper might have against Nuveen. (Stip. ¶68; PX 12 through 16, 37.)

20. Nuveen strongly recommended to the holders of WH commercial paper that they consent to the plan of distribution and the Liquidating Trust of WH. (Stip. ¶69; PX 49.)

21. Nuveen advised commercial paper holders that the trustee of the WH Liquidating Trust would make distributions of liquidating dividends only to those holders of WH commercial paper who had consented to the Liquidating Trust and who had surrendered to the Chicago Title and Trust Company their WH notes to be held for safekeeping. (Stip. ¶70; PX 64a through o.)

22. Henry T. Sanders, the plaintiff in this action, refused and has continued to refuse to consent to the Liquidating Trust of WH. Under date of December 16, 1970 Mr. J.R. Hanson, Chairman of the WH Creditors Committee, solicited the consent of the

lenders to a first amendment to the WH Liquidating Trust, dated as of December 15, 1970. That amendment provided, *inter alia*, that the WH note held by plaintiff Henry Sanders could be paid in full by the Liquidating Trust. (Stip. ¶75; PX 41.)

23. The WH Liquidating Trust became effective on February 11, 1971. The Trust has made several distributions to creditors of WH, including holders of WH short-term notes, but those notes have not been paid in full and various amounts remain unpaid on the notes. (Stip. ¶77.)

24. The plaintiff Henry T. Sanders has received no distribution from the Liquidating Trust (Stip. ¶82), nor any payment from Nuveen on the WH Note held by him, even though plaintiff made demand for such payment from Nuveen. (Stip. ¶23; Tr. 139.)

The Underwriting And Sale Of WH Commercial Paper By Nuveen And The Commercial Paper Operations Of Nuveen.

25. Nuveen made no examination or investigation of the corporate affairs, business or financial condition of WH prior to the time Nuveen commenced to underwrite and sell commercial paper issued by WH, or by any other issuer. (Tr. 202, 230–1, 234–5, 358, 415.) WH had been an account of Ashwell & Co., and Nuveen simply took over the account. (Tr. 231, 307.) Prior to the acquisition of its business and assets by Nuveen, Ashwell & Company had not made any independent examination or investigation of the financial condition or corporate affairs of WH. (Tr. 230.)

26. Prior to July, 1969 Nuveen, together with its affiliate, Nuveen Corporation, employed 172 registered representatives to sell securities, including commercial paper; and Nuveen operated 17 branch offices located throughout the United States. Nuveen was not engaged in any nonsecurities business. (Stip. §7; PX 2, 4; Tr. 208, 340.)

27. From September, 1968 until February 10, 1970, except for two notes issued by WH in a total amount of $60,000, Nuveen purchased all the commercial paper issued by WH, and either held in inventory or resold that paper to individual investors, firms, banks and insurance companies throughout the United States. In selling and delivering the commercial paper of WH, Nuveen made use of the U.S. mails and other instrumentalities of interstate commerce. (Stip. ¶10.) Nuveen purchased WH notes at a discount and then offered and sold the notes to buyers at a lower discounted rate, or higher price, in order to realize a profit. The buyer was thus able to generate a return on his investment, and Nuveen was able to realize a profit from the sale of the notes. The trading securities ledgers of Nuveen show that very often WH notes were 'rolled over' by Nuveen; i.e., at the due date of the notes new notes were issued to the buyer in payment of and to replace the old due notes. (PX 74, 5.)

28. From September, 1968 through December, 1968 Nuveen purchased from WH and sold to other parties, or held in its inventory, commercial paper of WH in total amounts outstanding which ranged from a low of $2,618,000 in December, 1968 to a high of $2,890,000 in October, 1968. (Stip. ¶14; PX 44.) In the year 1968 there was issued and outstanding commercial paper of WH in total amounts which ranged each month from a low of $1,915,000 in January, 1968, to a high of $4,064,500 in April, 1968. (Stip. ¶14.) From January 1, 1969 to June, 1970 Nuveen purchased $9,171,500 face value of WH discounted notes which Nuveen sold for $9,305,500. (Defs' Ans. to Interrogatory #3.)

29. Nuveen maintained a trading security ledger for each piece of commercial paper of WH sold by it and recorded each sale of WH commercial paper, and each cancellation, exchange or extension thereof. (Stip. ¶¶15, 16; PX 74, 75.)

30. In the period 12/1/68 to 12/31/69 Nuveen realized a gross profit from its dealings in commercial paper of $410,415.61.

(Stip. ¶7; PX 3.) Over half of the WH notes sold by Nuveen were purchased by individuals or were purchased for the accounts of individuals. Other purchasers were banks and insurance companies.

31. The number of issuers of commercial paper turned over to Nuveen by Ashwell was approximately 40. (Tr. 367.) While Nuveen was in the business of selling commercial paper it sold the commercial paper of 40 to 50 issuers at any one time. (Tr. 407.)

32. At no time while Nuveen was in the business of selling commercial paper did Nuveen adopt or promulgate any written procedures, instructions or directives for the sale of commercial paper. (Tr. 190, 199, 531.) Nuveen traded in commercial paper in the same manner it traded in other securities handled by it. (Tr. 239.) While the entire Nuveen sales department was authorized to sell commercial paper, the only instructions given to Nuveen salesmen with reference to the sale of commercial paper occurred on a Sunday morning in October, 1968, during a week-end conference of all Nuveen's salesmen. (Tr. 553–4.) While Nuveen did not establish or adopt any system of rating the commercial paper sold by it (Tr. 203, 241), the system of rating commercial paper followed by the National Credit Office ("NCO"), a subsidiary of Dun and Bradstreet, was explained to the Nuveen salesmen. (Tr. 240).

33. Richard Franke, the executive vice president of Nuveen, testified that Nuveen salesmen did not have enough knowledge to sell commercial paper on a day-in, day-out basis. (Tr. 210.) Yet, after the first 60 days that Nuveen began selling commercial paper most of Nuveen's salesmen sold commercial paper to their customers directly. (Tr. 239.)

34. Nuveen established no written criteria or standards as to the financial condition, size, or worth to be met by issuers whose commercial paper was sold by Nuveen. (Tr. 199.) Nuveen had no

written or verbal requirement that issuers of commercial paper have audit reports certified by a certified public accountant. (Tr. 214, 223.)

35. Nuveen customarily prepared credit reports on issuers of commercial paper sold by Nuveen, and these reports were given to buyers or potential buyers of commercial paper from Nuveen. (Stip. ¶12; Defs' Ans. to Interrogatory 7; PX 11, 97, 102–110; Tr. 128; Defs' Ans. to Request to Admit Facts ##1–5.) Other than the credit reports, Nuveen did not advise its salesmen to give buyers of commercial paper any information concerning the financial condition of the issuers of commercial paper being sold to those buyers or to inform the commercial paper buyers of the rating of the commercial paper Nuveen sold to them. (Tr. 250.) Nuveen sold commercial paper on the basis, in the words of the head of Nuveen's commercial paper department, Dale Daniels, "that there should be no question but what the paper will be paid at maturity." (Tr. 339.)

36. Nuveen used the instrumentalities of Interstate commerce to deliver to each member of the plaintiff class a confirmation statement of the purchase by each member of a note issued by WH. (PX 68; Deposition of Donald G. Reid, Tr. 10/20/78, pp. 20–22.) Each confirmation statement showed the date the note purchased was due to be paid, and the amount to be paid on the due date. (PX 68.)

37. All of the commercial paper sold by Nuveen, including that issued by WH, was rated "Desirable" by NCO, in a rating system in which "Prime" was the highest quality category and "Desirable" was the second quality category. Nuveen handled or sold no commercial paper rated "Prime" by NCO. (Tr. 203, 536.)

38. A.G. Becker and Company ("Becker"), a brokerage firm and a dealer in commercial paper, sold WH notes for a period from 1965 to 1967. Becker ceased selling WH notes for a period

from 1965 to 1967. Becker ceased selling WH notes in 1967 because WH paper was not "Prime" and it was not desirable and profitable to deal in notes rated "Desirable," and because WH issued a relatively small amount of commercial paper. (Tr. 380–3.)

39. There is no evidence or testimony that anyone employed by or connected with Nuveen ever examined the corporate minutes or records of corporate actions of WH. The corporate minutes of WH had not been reviewed by WH's auditors since 1966 and were in "very poor shape." (Stip. ¶46.)

40. Commencing November 1, 1968 Nuveen hired David A. Vermeer to investigate the credit of the issuers of commercial paper sold by Nuveen. (Tr. 387.) Until July , 1969, Vermeer was solely responsible for investigating the credit of all the issuers of commercial paper sold by Nuveen. (Tr. 196–7, 387.) Vermeer estimated that he spent 80% of his time checking the credit of issuers of commercial paper and 20–25% of his time on other activities. (Tr. 413.)

41. In checking the credit of an issuer of commercial paper, Vermeer examined the issuer's audit reports and the NCO reports on the issuer that were in Nuveen's files. (Tr. 397.) To some extent Vermeer relied on the NCO reports. (Tr. 398.) Vermeer would also address credit inquiries concerning WH to banks which were lenders to WH. Vermeer testified that the replies from banks did not tell anything about the actual financial strength of the company. (Tr. 618–9.) Dale Daniels, who was in charge of Nuveen's commercial paper department from October, 1969 to June, 1970, when Nuveen discontinued its commercial paper operations, confirmed Vermeer's testimony, stating, "You don't get a credit evaluation out of the banks." (Tr. 352.)

42. Vermeer analyzed the audit reports received by Nuveen from issuers of commercial paper sold by Nuveen and from them computed some 30 ratios—debt to capital, receivables to loans,

income to investment, etc. He entered all these ratios in sheets called "spread sheets." (Tr. 389–90; JX 4; Tr. 579–80.) This was Nuveen's usual procedure in checking credit of an issuer. (Tr. 350.) The audit reports were analyzed only for the purpose of computing the ratios, and not for the purpose of checking the accuracy of the audit reports. (Tr. 406–7.)

43. Vermeer also made on-site inspections of the premises of finance companies whose commercial paper Nuveen sold, and examined some of their records, primarily to determine whether their notes receivable were legitimate. (Tr. 580.) Vermeer also reviewed with the senior officers of the finance companies accounting, collection and repossession procedures. (Tr. 580.) Vermeer would spend one or two days at the offices of an issuer and write a report of his visit which was placed in Nuveen's files. No on-site inspection was made by Vermeer, or by anyone else at Nuveen, prior to or at the time Nuveen commenced to sell the commercial paper of an issuer. (Tr. 415, 202, 230–1, 358.)

44. Nuveen obtained its credit information on WH from audit reports prepared by LB. (Tr. 406, 212, 358–9, 362.) Nuveen's personnel did not know and had never met anyone at the accounting firm of LB. (Tr. 243, 401.) Nuveen never addressed any inquiries to LB. (Tr. 243–4, 406.)

45. Vermeer first worked on the WH account in December of 1968 when he spread the ratios for three years from WH financial statements. (Tr. 389.) He used the figures from the 8/31/68 audit of WH by LB, and wrote a report on WH based on the computation of ratios from the WH audit reports.

46. In March, 1969 Vermeer visited WH's offices. Vermeer examined the accounts receivable cards of WH and the actual notes receivable, for the purpose of determining whether the receivables were good, how much delinquency on payments existed, and whether the receivables were aged properly. (Tr. 605–10.)

47. Vermeer did not examine any internal control or accounting records of WH (Tr. 394), or the records of WH's payables and liabilities. Nor did Vermeer examine any corporate minutes of WH. (Tr. 394.) It was Vermeer's practice to examine federal income tax returns of issuers whose notes were sold by Nuveen, and Vermeer testified he "most likely did" examine WH's income tax returns when he made his on-site inspection of WH. (Tr. 411.)

48. In July, 1969 Vermeer was discharged by Nuveen. While Richard Franke testified that Vermeer was released because he was not a "self-starter" and was not busy enough (Tr. 6–7), Vermeer's discharge by Nuveen coincided with the release of some 200 employees by Nuveen and by discontinuance of Nuveen's stock or equity trading sales department. (Tr. 195.) Their discharges resulted in part from financial difficulties and large losses in Nuveen's bond department due to the tight money situation. (Tr. 347.) Vermeer was not replaced. (Tr. 197.)

49. By November 15, 1969 Nuveen had reduced its operations to 13 branch offices and had greatly reduced the number of its employees. (Stip. ¶8; PX 6.)

50. Donald Reid, the head of Nuveen's commercial paper department since September, 1968, assumed the credit checking responsibilities Vermeer had fulfilled. Reid testified that he was over-burdened and did not have time to do credit investigations. (Tr. 236.)

51. Reid officed in Chicago, Illinois, and had direct contact with all issuers of commercial paper sold by Nuveen which were located west of Ohio. Dale Daniels officed in New York and had direct contact with all issuers whose notes Nuveen sold which were located east of Ohio. (Tr. 303–306.) The offices of WH were located in Chicago and came under Reid's supervision. (Tr. 308.)

52. Reid left Nuveen at the end of October, 1969 and Dale Daniels became the head of Nuveen's commercial paper department in November, 1969. (Tr. 304–5.) Reid assigned as one of his reasons for leaving Nuveen the fact that IDS, which had acquired all the stock of Nuveen through its wholly-owned subsidiary, Investors Syndicate of America, would not honor his request for additional people. (Tr. 244.)

53. Wahlberg testified that instructions were given in October, 1969 to hire a credit investigator in the commercial paper department—not to replace Reid, but as additional personnel Wahlberg felt was needed. (Tr. 532.) Wahlberg further testified that he knew Daniels was not familiar with the accounts handled by the Chicago office, and that was why Nuveen needed a new credit man. (Tr. 532–3.) Even though Nuveen had no written policies or directives with reference to commercial paper (Tr. 531), Wahlberg assumed Nuveen's methods were good because of Nuveen's fine reputation. (Tr. 530–1.) Franke testified Nuveen relied on Wahlberg for expertise in commercial paper operations. (Tr. 200–1.)

54. In December, 1969 Nuveen hired Richard Ferreira as a credit investigator in its commercial paper department. (Tr. 201.) From that date to June, 1970, when Nuveen ceased selling commercial paper, Ferreira was the only person at Nuveen involved in checking credit of commercial paper issuers. (Tr. 367–8.) A month after Reid left, the Nuveen commercial paper department consisted of Daniels, Ferreira, and two salesladies. (Tr. 367–8, 207.)

55. Ferreira analyzed the issuers' audit reports and examined the NCO reports, and brought Vermeer's spread sheets up to date. (Tr. 358–9, 365.) Ferreira made no on-site inspections in the six months he was with Nuveen. (Tr. 358.)

56. Commencing in December, 1969 Daniels made a whirlwind tour to familiarize himself with the commercial paper

handled by Nuveen's Chicago office. (Tr. 306, 310.) In late December, 1969 Daniels had lunch with Hirsch in Chicago, primarily to establish contact with WH. (Tr. 310–11.) Daniels noted that Hirsch looked ill and ordered Ferreira to do a credit report on WH. (Tr. 310–11, 312–4, 365.)

57. Before Ferreira was employed by Nuveen in December, 1969, he had never analyzed the credit of an issuer of commercial paper. (Tr. 357.)

58. Ferreira did not visit the WH offices, nor meet or talk with WH personnel or examine any WH records. (Tr. 358, 365–6.)

59. Ferreira prepared a credit report on WH dated January 12, 1970. (PX 11.) For that report Ferreira used only the 8/31/69 LB audit statement on WH. (Stip. ¶12; Tr. 361–2.) Ferreira reported that the LB audit statement was a "detailed audit" of WH. (PX 11.) In the comment portion of WH's 8/31/69 audit LB stated they had not made a detailed audit (JX 3) and the NCO reports on WH noted that the WH audits were not detailed audits. (JX 5; PX 30; PX 100.) When the comments of the auditor in the 8/31/69 WH statement were brought to his attention, Ferreira testified that in his opinion the statement was unaudited. In his report on WH, Ferreira rated the commercial paper of WH as "Desirable" (PX 11)—the same rating given WH paper by NCO. (JX 5; PX 30; PX 100.)

60. Ferreira made no credit inquiries of banks or other lenders to WH prior to writing his 1/12/70 report on WH. On January 22, 1970, at the urging of Daniels, Ferreira sent inquiries on WH to a dozen banks. (DX 3–9.) Three of the banks did not reply to Ferreira's credit inquiries (Stip. ¶52; Tr. 370–1), of which at least two were fully aware of the investigations of WH undertaken by WH's lenders. On February 10, 1970, Verne Istock of the National Bank of Detroit, who had returned from a vacation, telephoned Nuveen and ultimately reached Daniels and told him of

the investigation of WH. (Tr. 497–9.) Istock suggested that Daniels talk with Hanson of the First National Bank of Chicago (one of the banks that had not responded to Ferreira's inquiry). Daniels did so, was informed of the investigation and audit of WH. On February 10, 1970, Nuveen suspended the sale of WH commercial paper.

61. Upon the recommendation of Daniels, Nuveen stopped dealing in commercial paper in June, 1970. Daniels gave as his reasons for the discontinuance that he felt he was a commercial paper operator in a bond house, and he felt uncomfortable. (Tr. 344.) Daniels testified he had neither the support nor the technical operation necessary to run a commercial paper operation (Tr. 344), and that he "never felt that John Nuveen & Company was a company to do a job in commercial paper . . ." (Tr. 344.)

The Lieber And Bleiweis Audit Reports on Winter And Hirsch, Inc.

62. The WH audit reports prepared by LB for the years ended 8/31/68 and 8/31/69 (JX 1, 3), and the report for the six month period ended 2/28/69 (JX 2), are "long form reports"; *i.e.*, the audits contain a description of the methods, procedures and scope of the examination conducted by the auditors, as contrasted with a "short form report," which is a statement that the auditors' investigation was made in accordance with generally accepted auditing standards. (PX 95.)

63. In the WH audit reports which are relevant here, which were furnished by WH to Nuveen, and on which Nuveen relied in determining the creditworthiness of WH, LB made the following comments, among others:

> (a) "Our examination was directed to the verification of the financial condition of the company at [date] and included a general review of the income and expense accounts, but

without detailed audit of the transactions for the [period of time] then ended." (JX 1–3.)

(b) "Requests for verification [of accounts receivable] were mailed during the period under review to all of the debtors in accordance with company policy whereby all accounts are circularized by management three times per year." (JX 1–3.)

(c) "Provision for federal income taxes for the current year is based upon current rates including provision for applicable tax surcharge." (JX 1–3.)

(d) "In our opinion, based upon the foregoing comments, the accompanying consolidated balance sheet and related consolidated statements of income and expenses and surplus present fairly the financial condition of WINTER AND HIRSCH, INC.... at [date] and the results of its operations for the [period of time] then ended in conformity with generally accepted accounting principles . . ." (JX 1–3.)

64. The statement set forth in ¶63(a) above is descriptive of an attempt to determine a balance sheet for WH at a given point in time, and is not a statement that the auditor attempted to determine the results of operations of WH. (Tr. 70–1.)

65. From the statement set forth in ¶63(b) above it cannot be determined who circularized the accounts receivable, management or the auditor. (Tr. 74–6.)

66. The statement set forth in ¶63(a) above, to the effect that the auditor's examination is "without detailed audit of the transactions for the year then ended," does not indicate that the auditor had audited any or some of the transactions of WH. (Tr. 70–3.) Reid testified that such language is not usual or consistent with a good or unqualified audit report. (Tr. 242–3.) Ferreira testified that this language meant that the statement was unaudited. (Tr. 364.)

67. The phrase "based on the foregoing comments," which precedes the auditor's opinion (¶63(d) above), is unusual language in a certified audit. (Tr. 69–70.) That phrase is not gratuitous when appearing in an auditor's report, and that "comments" to which reference is made in the auditor's opinion are not gratuitous. (Tr. 559.) The effect of the phrase is that the comments which precede the auditor's opinion must be examined to determine the validity or qualification of the opinion. (Tr. 562.)

68. The statement set forth in ¶63(c) above, appearing in the auditor's report, is meaningless and gives no indication of the status of the tax filings of WH or the correctness of the provision for taxes contained in WH's financial statements. (Tr. 76–7.)

69. There is no statement in the WH audit reports (JX 1, 2 or 3) that the auditors tested the internal control records of WH. (Tr. 72–3, 78.) It was by manipulation of the control records—ledgers, summaries of receivables and payables—that WH effected a fraud upon its creditors, including the holders of notes issued by WH.

70. Nuveen was unable to state whether or not it had delivered a Nuveen commercial paper report on WH to 18 members of the plaintiff class who filed answers to interrogatories stating they had received such a report, and attaching to their answers a copy of the WH report each of them received from Nuveen. (Answers To Request To Admit Facts ##3, 4, 5, Tr. 10/20/78, pp. 15–16.)

71. Plaintiff Gerald Tapp was told by Nuveen representative Joe Chandler that WH was a "very good" company; and Chandler sent to Tapp a Nuveen report on WH. (Tr. 10/20/78, pp. 26–29.)

72. Robert Kuehl was an officer of plaintiffs Q.R.F. Corporation and Trinity Grace United Methodist Church, and was engaged with plaintiff Russell C. Kuehl in a partnership known as

Kuehl Brothers. (Tr. 10/20/78, pp. 35–36.) Robert Kuehl, on behalf of Q.R.F. Corporation, purchased from Nuveen a WH Note on December 1, 1969. (Tr. 10/20/78, p. 44). Prior to making that purchase Nuveen representative Eugene Johnson told Robert Kuehl that commercial paper would be a suitable investment for Q.R.F. Corporation. (Tr. 10/20/78, p. 38.) Another Nuveen employee, Miss Evans, summarized a WH financial statement for Robert Kuehl, and advised him that WH was one of two firms with notes Nuveen had for sale which would "take commercial paper" in an amount as low as the $3,000 Q.R.F. wished to invest. Miss Evans also told Robert Kuehl that WH was a good company and recommended it for purchase by Q.R.F. Corporation. (Tr. 10/20/78, p. 40.) Subsequently, Miss Evans sent Robert Kuehl a commercial paper report on WH dated 8/69. (PX 106; Tr. 10/30/78, pp. 40–41.) On January 5, 1970 Robert Kuehl caused plaintiffs Kuehl Brothers and Trinity Grace United Methodist Church to purchase WH notes. (Tr. 10/20/78, pp. 45–6.) Robert Kuehl showed PX 106 to the trustees of Trinity Grace United Methodist Church prior to the time such purchases were made. (Tr. 10/20/78, p. 46.)

73. Plaintiff Russell C. Kuehl was told by Nuveen representative Eugene Johnson on January 2, 1970 that WH notes would be an appropriate investment for him for a short term, possibly four or five months. (Tr. 10/20/78, pp. 54–55.) On January 5, 1970 Russell C. Kuehl purchased a WH Note from Nuveen. (Tr. 10/20/78, p. 53.)

74. Russell C. Kuehl purchased a WH note from Nuveen on behalf of plaintiff Jennie M. Clark on January 12, 1970. (Tr. 10/20/78, p. 56.) On that date Nuveen representative Eugene Johnson told Russell C. Kuehl that WH was an appropriate investment for Jennie M. Clark, and recommended that Jennie M. Clark purchase WH notes. (Tr. 10/20/78, pp. 56–58.)

75. Plaintiff Robert Abram purchased a WH note from Nuveen on January 29, 1970. (Tr. 10/30/78, pp. 62–63.) Prior to that purchase Nuveen representative Patrick Brannen recommended that Abram purchase a WH note, and told Abram that WH notes were rated "double A". (Tr. 10/20/76, pp. 65–66.) Nuveen also sent Abram a report on WH. (PX 110; Tr. 10/20/78, pp. 67–68.)

76. On January 5, 1970 Clifford M. Johnson caused the Thora M. Johnson Trust, of which he was a trustee, to purchase from Nuveen a WH note. (Tr. 10/20/78, pp. 72–74.) Prior to that purchase Nuveen representative Miss Evans recommended that the Trust purchase WH notes and told Clifford M. Johnson that WH was a "good company", and Nuveen 'wouldn't recommend them unless they were 100 percent." (Tr. 10/20/78, p. 77.)

Conclusions of Law

C-1. This Court has jurisdiction over the parties and over the subject matter of this action under the Securities Act of 1933, 15 U.S.C. §77a, *et seq.*

C-2. The notes issued by WH and sold by Nuveen to the plaintiff class are securities as that term is defined in §2(1) of the Securities Act of 1933, 15 U.S.C. §77b(1). *Sanders v. John Nuveen & Co.*, 463 F.2d 1075 (7th Cir. 1972), *cert. denied*, 409 U.S. 1009 (1972).

C-3. The notes issued by WH and sold by Nuveen were not prime quality negotiable commercial paper, and were sold by Nuveen in interstate commerce and by use of interstate facilities to the general public for investment purposes.

C-4. Nuveen was an underwriter of the notes issued by WH and purchased by the plaintiff class. 15 U.S.C. 77b(11); *S.E.C. v. Van Horn*, 371 F.2d 181 (7th Cir. 1966). Nuveen also was a dealer in WH notes. 15 U.S.C. 77b(12).

C-5. It was the duty of Nuveen as an underwriter, under §12(2) of the Securities Act of 1933, 15 U.S.C. §78*l*(2), to make an investigation of WH calculated to reveal all facts material to an informed investment decision by a reasonably prudent investor, to enable Nuveen to form a belief as to the accuracy of the representations made by WH, and to provide Nuveen with reasonable grounds for believing that the financial condition of WH was such that WH would have the ability to pay its notes as they matured. *Sanders v. John Nuveen & Co.*, 524 F.2d 1064 (7th Cir. 1975); *Alton Box Board Company v. Goldman, Sachs & Co.*, 560 F.2d 916 (8th Cir. 1977); *Franklin Savings Bank v. Levy*, 551 F.2d 521 (2d Cir. 1977); *University Hill Foundation v. Goldman, Sachs & Co.*, 422 F. Supp. 879 (S.D.N.Y. 1976); *S.E.C. v. Goldman, Sachs & Co.*, CCH Fed. Sec. L. Rep., 1973–1974 Transfer Binder, ¶94,556 (S.D.N.Y. 1974.)

C-6. A reasonable investigation of WH by Nuveen required a first-hand examination of WH's corporate records, income tax returns and accounting records by Nuveen, as well as inquiry of WH's auditors concerning the audits purportedly made by them. *Sanders v. John Nuveen & Co.*, 524 F.2d 1064 (7th Cir. 1975).

C-7. Nuveen failed to make a reasonable investigation of the corporate and tax affairs and the financial condition of WH prior to the sale of WH notes to members of the plaintiff class.

C-8. As a dealer in the notes of WH Nuveen had a duty to properly analyze the statements and audit reports of WH, to investigate the reliability and accuracy of those statements, and to form an adequate basis for recommending or selecting WH paper for purchase by members of the plaintiff class. *Hanly v. S.E.C.*, 415 F.2d 589 (2nd Cir. 1969).

C-9. The audit reports for WH prepared by LB, and sent to Nuveen, contained comments by the auditors which should have prompted inquiry by Nuveen as to the competence and reliability

of the auditors and of the audit statements, and should have raised doubts and suspicions on the part of Nuveen as to whether the auditors had followed generally accepted auditing standards and procedures.

C-10. The WH audit reports prepared by LB and sent to Nuveen contained comments by the auditors that were so unusual and qualified, and so ambiguous with reference to subjects such as tax liabilities and filings, and verification of accounts receivable, that Nuveen could not reasonably have relied upon them without making further inquiry and investigation.

C-11. The analysis of the WH audit reports made by Nuveen was inadequate and erroneous and Nuveen was negligent in failing to investigate and verify the auditing procedures followed by LB in preparing the WH audit reports sent to Nuveen and the accuracy and reliability of those reports. Nuveen's reliance on the WH audit reports was unreasonable and unwarranted.

C-12. The Commercial Paper Reports (PX 102-PX 107) and confirmation statements (PX 68) prepared by Nuveen were "prospectuses" within the meaning of §12(2) of the Securities Act of 1933, 15 U.S.C. §77*l*(2).

C-13. The Commercial Paper Reports and confirmation statements were transmitted and delivered to class members, or their agents, by Nuveen by "means or instruments of transportation or communication in interstate commerce or of the mails" within the meaning of §§12 and 5 of the Securities Act of 1933, 15 U.S.C. §§77*l*, 77e.

C-14. The WH notes were sold and offered to be sold to each member of the plaintiff class by means of, or through the use or medium of, prospectuses within the meaning of §12(2) of the Securities Act of 1933, 15 U.S.C. §77*l*(2).

C-15. Nuveen offered to sell and sold securities by means of oral communications to the following members of the plaintiff class: Henry T. Sanders, Gerald R. Tapp, Q.R.F. Corporation, Trinity Grace United Methodist Church, Kuehl Brothers, Russell Kuehl, Jennie M. Clark, Robert Abram and Clifford M. Johnson and Eugene Johnson, as Trustees of the Thora M. Johnson Trust.

C-16. In selling and offering to sell WH notes to the plaintiff class by means of oral communications and/or prospectuses, Nuveen made untrue statements of material fact and omitted to state material facts necessary in order to make the statements in said prospectuses and oral communications not misleading.

C-17. Each member of the plaintiff class purchased a WH note or notes for purposes of investment in order to realize a return on the money invested, without knowledge that WH would not pay when due the notes purchased.

C-18. In selling and offering to sell WH notes to the plaintiff class by the use of interstate commerce and the mails, by means of oral communications and/or prospectuses which included untrue statements of material fact and omitted to state material facts necessary in order to make the statements, in light of the circumstances under which they were made, not misleading, Nuveen is liable under §12(2) of the Securities Act of 1933, 15 U.S.C. §77*l*(2), to each member of the plaintiff class.

C-19. Nuveen is liable to each member of the plaintiff class for violating §12(1) of the Securities Act of 1933, 25 U.S.C. §77*l*(1), by offering and selling the WH notes to the class without first having filed a registration statement with the Securities and Exchange Commission, in violation of the provisions of §5 of said Act, 15 U.S.C. §77e.

JUDGMENT

This Court, having entered simultaneously herewith its Findings of Fact and Conclusions of Law, does hereby consider, order and adjudge as follows:

1. Nuveen, Investors Diversified Services and Investors Syndicate of America, Inc., jointly and severally, shall pay to each member of the plaintiff class who has filed a claim in this action pursuant to the Judgment Order of October 15, 1974, which claim was allowed by order of this Court dated January 27, 1975, the principal amount of each said claim remaining unpaid, together with interest on the balance of the principal amount of each such claim which was outstanding and unpaid from time to time, at the rate of six percent (6%) per annum, from the maturity date of each WH note forming the basis of such claim until October 1, 1977, and thereafter at the rate of seven percent (7%) per annum until the date of this Judgment.

2. Plaintiffs' attorneys shall, within ten (10) days of the date hereof, file with this Court an itemization of the amount of principal and interest due to be paid each member of the plaintiff class hereunder. Within ten (10) days thereafter defendants may file an objection to said itemization of amounts, and a hearing on any such objection will be set by this Court.

3. After entry of a final order herein defendants shall prepare and deliver to the Clerk of this Court funds in exchange for the WH notes and assignments of interest in the WH Liquidating Trust previously filed herein by each member of the plaintiff class, in an amount equal to the total claims of the members of the plaintiff class allowed by this Court. The Clerk of the Court shall hold said funds subject to further order of this Court directing the disbursement and distribution of said funds. All costs of disbursement of said sums shall be paid by defendants.

4. Plaintiffs shall recover their costs of suit.

5. Plaintiffs' attorneys shall submit their petition for an award of attorneys' fees and reimbursement of expenses

within thirty (30) days of the date hereof. Defendants may file any objection they may have to the petition for attorneys' fees within fifteen (15) days thereafter. The Court shall set for hearing and disposition said petition, with appropriate notice to the plaintiff class.

6. This Court retains jurisdiction of this action to correct, modify, annul, vacate and supplement the foregoing Judgment Order.

Dated at Chicago, Illinois this 10th day of January 1979.

ENTER:

/s/ J. PERRY

District Judge

HENRY T. SANDERS, *Plaintiff-Appellee,*

v.

JOHN NUVEEN & CO., INC., et al.,
Defendants-Appellants.

Nos. 74-2047, 75-1260.

United States Court of Appeals,
Seventh Circuit.

Argued Dec. 10, 1976.
Decided April 22, 1977.

As Modified on Denial of Rehearing
En Banc June 8, 1977.

Before CASTLE, TONE and WOOD, Circuit Judges.

HARLINGTON WOOD, Jr., Circuit Judge.

On April 19, 1976, the United States Supreme Court granted defendants' Petition for Certiorari, and vacated this court's order entered on October 30, 1975, in *Sanders II*,[1] 524 F.2d 1064 (7th Cir. 1975), and remanded the case for reconsideration in light of the Supreme Court's intervening decision in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 96 S.Ct. 1375, 47 L.Ed.2d 668 (1976), reversing 503 F.2d 1100 (7th Cir. 1974). On May 28, 1976, the defendants moved this court to summarily reverse the judgment below. That motion has been taken with the case.

[1]In *Sanders I*, 463 F.2d 1075 (7th Cir. 1972), *cert. denied*, 409 U.S. 1009, 93 S.Ct. 443, 34 L.Ed.2d 302 (1972), this court considered four issues certified by the district judge pursuant to 28 U.S.C. §1992(b), and held generally that promissory notes with maturity dates not exceeding nine months and offered to the public as an investment were "securities" within the definition of the Securities Exchange Act of 1934; and also that it was error to permit creditors of the issuer of the short term securities with antagonistic interests to the class of purchasers represented by plaintiff to intervene without notice to that class.

As the facts are fully set forth in *Sanders I and II* only a brief factual recap for convenience is included here. This is a class action brought for and in behalf of forty-two purchasers of fifty-three short term notes in the aggregate face amount of $1,612,500 purchased during a seven month period in 1969 and 1970. Defendant John Nuveen & Co., Inc., was found to be the underwriter of that commercial paper issued by Winter & Hirsch, Inc., a consumer finance company, during that period just prior to the default of Winter & Hirsch, Inc., on its obligations in 1970. The remaining defendant corporations were found to be "controlling persons" of Nuveen.

In *Sanders II* the principal question was stated to be "whether an underwriter of short term commercial paper who acted in the mistaken but honest belief that financial statements prepared by certified public accountants correctly represented the condition of the issuer is liable to its customers for losses sustained as a result of the issuer's default." 524 F.2d at 1066. The district court held Nuveen liable on the theory that it breached a duty to make reasonable inquiries that would have led to the discovery of issuer's fraud. This court affirmed.

The problem now is to determine the effect of *Hochfelder* on this case. In *Hochfelder* the majority held that "scienter", that is, an intent to deceive, manipulate or defraud, is required to establish a private cause of action for damages under §10(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j(b) and Rule 10b-5 thereunder, 17 C.F.R. 240.10b-5. Negligence is not sufficient. The Court added: "In certain areas of the law recklessness is considered to be a form of intentional conduct for purposes of imposing liability for some act. We need not address here the question whether, in some circumstances, reckless behavior is sufficient for civil liability under §10(b) and Rule §10b-5." 425 U.S. at 194 n. 12, 96 S.Ct. at 1381. The Court further noted that there are certain express civil remedies subject to significant

procedural restrictions provided in the Securities Act of 1933,[2] allowing recovery for negligent conduct including the remedy provided in §12,[3] and explained that "Section 12(2) creates potential civil liability for a seller of securities in favor of the purchaser for misleading statements or omissions in connection with the transaction. The seller is exculpated if he proves that he did not know or in the exercise of reasonable care, could not have known of the untruth or omission."[4]

Plaintiff's complaint as amended asserts claims under §§12(2) and 17 of the Securities Act of 1933, 15 U.S.C. §§77*l*(2) and 77q, §§10(b) and 20 of the Securities Exchange Act of 1934, 15 U.S.C. §78j(b) and 78t, and Rule 10b-5 of the Securities Exchange Commission, 17 C.F.R. 240.10b-5.

In *Sanders II* this court found Nuveen's liability to rest on Rule 10b-5.[5] The first issue to be resolved is whether or not that holding remains valid. That depends on whether the record justifies a finding of "scienter" as defined in *Hochfelder*. In *Sanders II* this court viewed Nuveen's conduct as being mistaken but honest in belief. The trial court based its holding on negligence. Upon reconsideration, we find that the record is barren of any showing of actual intent to deceive, manipulate or defraud. Thus, the judgment cannot be supported on that basis.

In *Hochfelder* the Supreme Court left open the question of whether or not in some circumstances "reckless behavior", which was not there defined, could constitute scienter for civil liability under §10(b) and Rule 10b-5. We believe, contrary to Nuveen's urging, that "reckless behavior" can be sufficient to constitute scienter. We have already so held in *Bailey v. Meister Brau, Inc.*, 535 F.2d 982 (7th Cir. 1976), and recently and more specifically

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[2]15 U.S.C. §77a *et seq.*
[3]*Hochfelder, supra*, 425 U.S. at 208–209, 96 S.Ct. 1375.
[4]*Hochfelder, supra* at 209 n. 27, 96 S.Ct. at 1388.
[5]*Sanders II*, 524 F.2d at 1069.

in *Sundstrand Corporation v. Sun Chemical Corporation et al.*, 553 F.2d 1033 (7th Cir. 1977). *Sundstrand* explains that the standard in *Bailey* is akin to a reckless standard though phrased in terms of "blinded by conflict of interest" and "wantonly ignored". *Sundstrand* more definitely defines recklessness in the context of omissions by adopting as a base the definition in *Franks v. Midwestern Oklahoma Development Authority*, CCH Fed.Sec.L.Rep. ¶95.786 at 90.850 (W.D.Okl. 1976):

> reckless conduct may be defined as a highly unreasonable omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.

In view of the Supreme Court's analysis in *Hochfelder* of the statutory scheme of implied private remedies and express remedies, the definition of "reckless behavior" should not be a liberal one lest any discernible distinction between "scienter" and "negligence" be obliterated for these purposes. We believe "reckless" in these circumstances comes closer to being a lesser form of intent than merely a greater degree of ordinary negligence. We perceive it to be not just a difference in degree, but also in kind. Plaintiff argues for something less, relying in part on *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 95 S.Ct. 1917, 44 L.Ed.2d 539 (1975), where Mr. Justice Rehnquist, writing for the Court about the tort of misrepresentation and deceit, stated that "the typical fact situation in which the classic tort misrepresentation and deceit evolved was light years away from the world of commercial transactions to which Rule 10b-5 is applicable." 421 U.S. at 744–745, 95 S.Ct. at 1929. That comment is made in relation to privity of dealing. Personal contact between potential defendant and potential plaintiff in "today's universe of commercial transactions" is recognized as the exception and not the rule. The Court in *Blue Chip Stamps* limited the benefit of Rule 10b-5 to actual purchasers or sellers of securities, and excluded those

who claim they did not enter into a transaction which later turned out to be better than they had anticipated because of an alleged misleading and pessimistic prospectus. That case does not hold that none of the old concepts of fraud and deceit, or recklessness, have application in the present context.

In the present case the trial judge found that Nuveen, due to negligence, made misleading statements of material fact and omitted to make statements of material fact necessary to make the statements not misleading in selling the notes to members of the plaintiff class. Underlying is the finding that Nuveen's investigation of the issuer was deficient and that an appropriate investigation would have revealed the issuer's fraud. There was no finding that Nuveen's acts of commission or omission were reckless, that is, that they were so highly unreasonable and such an extreme departure from the standards of ordinary care as to present a danger of misleading the plaintiff to the extent that the danger was either known to the defendant or so obvious that the defendant must have been aware of it. On reviewing the record we likewise find no basis to sustain the judgment because of any reckless conduct on the part of Nuveen.

Therefore, at this point, as we now view the case, we must determine whether we are compelled to allow Nuveen's motion for summary reversal of the judgment below, or whether upon remand to this court the permissible scope of our reconsideration is broad enough to permit consideration of other pleaded issues which were originally present in the case and which were not expressly or impliedly ruled upon by the Supreme Court in *Hochfelder*. We may not contravene a specific instruction or disregard the disposition of any question of law contained in the mandate. Nuveen relies on *Hermann v. Brownell*, 274 F.2d 842 (9th Cir. 1960), *cert. denied* sub. nom., *Herrmann v. Rogers*, 364 U.S. 821, 81 S.Ct. 56, 5 L.Ed.2d 50, but that case stands only for the proposition that upon the remand the jurisdiction of an appellate court

is limited to those particularized points which were assigned for consideration, if the mandate was in that form. However, the remand in the present case was broadly stated to be "for further consideration in light of *Hochfelder*." Other issues not within the compass of the mandate are thereby not precluded from consideration. *Sprague v. Ticonic National Bank*, 307 U.S. 161, 59 S.Ct. 777, 83 L.Ed. 1184 (1939). See also *Illinois Bell Telephone Co. v. Slattery*, 102 F.2d 58 (7th Cir. 1938), *cert. denied*, 307 U.S. 648, 59 S.Ct. 1045, 83 L.Ed. 1527 (1939).

Following that view we must next examine the other causes alleged by plaintiff and an additional approach urged by Amicus Curiae.[6] Plaintiff asserts that judgment in his behalf may be sustained under §17(a) of the 1933 Act, on the ground that Nuveen violated rule 27 of the National Association of Security Dealers, Inc., or under §12(2) of the 1933 Act. Amicus Curiae injects a new issue not framed by the parties by urging liability on the basis that defendants violated §5 of the Securities Act and are liable to plaintiff under §12(1) of the Securities Act because Nuveen sold unregistered securities to plaintiff. Amicus Curiae argues that the short term notes were not exempt from registration by virtue of §3(a)(3) of the '33 Act, 15 U.S.C. §77c(a)(3).[7] The basis of that argument is an alleged intent on the part of Congress to distinguish between transactions which were deemed to be within the realm of an investment context and thereby necessarily included

[6]The Securities and Exchange Commission filed a brief as Amicus Curiae after remand to this court.

[7]Section 3(a)(3) of the Securities Act of 1933, 15 U.S.C. 77c(a)(3), provides in pertinent part:

> 3(a) Except as hereinafter expressly provided, the provisions of this title shall not apply to any of the following classes of securities:
>
> (3) Any note, draft, bill of exchange, or banker's acceptance which arises out of a current transaction or the proceeds of which have been or are to be used for current transactions, and which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited;

within the protection of the securities laws and those transactions which were of an ordinary business nature, the regulation of which would unduly interfere with routine commercial practices. Although we have great doubt about the merits of the new argument advanced by Amicus Curiae, we need not pass upon it since plaintiff has not advanced it, *Knetsch v. United States*, 364 U.S. 361, 370, 81 S.Ct. 132, 5 L.Ed.2d 128 (1960), and, in fact, disclaims it.

The other claims which were pleaded by plaintiff deserve further consideration.

Plaintiff argues that the judgment should be sustained under §17(a) of the 1933 Act,[8] although no reference was made to that issue in the judgment order of the district court. Plaintiff takes the position that the implication of a private civil right of action under §17(a) of the 1933 Act is settled, relying in part on *Schaefer v. First National Bank of Lincolnwood*, 509 F.2d 1287 (7th Cir. 1975), *cert. denied*, 425 U.S. 943, 96 S.Ct. 1682, 48 L.Ed.2d 186 (1976), and *Surowitz v. Hilton Hotels Corporation*, 342 F.2d 596 (7th Cir. 1965), (dictum), *rev'd on other grounds*, 383 U.S. 363, 86 S.Ct. 845, 15 L.Ed.2d 807 (1966), but also

[8]Section 17(a) of the Securities Act of 1933, 15 U.S.C. §77q, provides, in pertinent part:

> 17. (a) It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—
>
> (1) to employ any device, scheme, or artifice to defraud, or
>
> (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (3) to engage in any transaction, practice or course of business which operates or would operate as a fraud or deceit upon the purchaser. . . .
>
> (c) The exemptions provided in Section 3 shall not apply to the provisions of this section.

recognizes that a contrary view exists, *Reid v. Mann*, 381 F. Supp. 525 (N.D. Ill. 1974). Nuveen disputes that a private right of action may be maintained under §17(a), relying in part on Judge Friendly's often quoted concurring opinion in *S.E.C. v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 867 (2d Cir. 1968) (en banc), *cert. denied sub nom. Coates v. S.E.C.*, 394 U.S. 976, 89 S.Ct. 1454, 22 L.Ed.2d 756 (1968),[9] and *Blue Chip Stamps v. Manor Drug, supra*, for the proposition that implied remedies should not be created if comparable express remedies are provided, such as §12(2) of the 1933 Act. Plaintiff, on the other hand, interprets *Blue Chip Stamps* to imply that §17(a) does give rise to a private cause of action. However, in *Blue Chip Stamps* the Court stated that it was expressing "no opinion on whether §17(a) in light of the expressed civil remedies of the 1933 Act, gives rise to an implied cause of action."[10]

For the purposes of this case we see no need to try to resolve those opposing views in an effort to decide whether a private right of action exists under §17(a) where it no longer has the accompanying support of a viable 10b-5 claim as noted in *Schaefer v. First National Bank of Lincolnwood, supra*, and considered in

[9]That quotation is as follows:

> [T]here is unanimity among the commentators, including some who were in a peculiarly good position to know, that §17(a)(2) of the 1933 Act—indeed the whole of §17—was intended only to afford a basis for injunctive relief and, on a proper showing, for criminal liability, and was never believed to supplement the actions for damages provided by §§11 and 12. *See Landis*, Liability Sections of the Securities Act, 18 Am.Acct. 330,331 (1933); Douglas and Bates, Federal Securities Act of 1933, 43 Yale L.J. 171, 181–82 (1933); 3 Loss, Securities Regulation 1785–86 (1961). When the House Committee Report listed the sections that "define the civil liabilities imposed by the Act" it pointed only to §§11 and 12 and stated that "[t]o impose a greater responsibility [than that provided by §§11 and 12] . . . would unnecessarily restrain the conscientious administration of honest business with no compensating advantage to the public." H.Rep.No. 85, 73d Cong., 1st Sess. 9–10 (1933).

[10]421 U.S. at 734 n. 6, 95 S.Ct. 1917 at 1924.

Reid v. Mann, supra. We need not reach that question since we are persuaded by defendants' additional position that even if such a private cause of action does exist under §17(a), it would require proof of scienter. Proof of scienter is unquestionably required as to subsections (1) and (3) which specifically refer to fraud. Subsection (2), on the other hand, does not expressly refer to fraud. In the 1933 Act, Congress expressly provided for civil liability in Sections 11 and 12(2)[11] premised upon negligent wrongdoing. Sections 11 and 12(2) are subject to specific restrictions: (a) the one year statute of limitations; (b) discretion in the court to require a bond; and (c) placing on defendants the burden of proving that they reasonably believed their statements to have been true, etc. Section 17(a) is not subject to similar restrictions. After noting that §10(b) is not subject to procedural limitations which apply to the express civil remedies in the 1933 Act allowing recovery for negligent conduct, the Court, in *Hochfelder*, stated:

> We think these procedural limitations indicate that the judicially created private damages remedy under §10(b)—

[11]Section 12(2) of the 1933 Act, 15 U.S.C. §77*l*(2) provides:

> Any person who—
>
> (2) offers or sells a security (whether or not exempted by the provisions of section 77c of this title, other than paragraph (2) of subsection (a) of said section), by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission,
>
> shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

> which has no comparable restrictions—cannot be extended consistently with the intent of Congress, to actions premised on negligent wrongdoing. Such extension would allow causes of action covered by §§11, 12(2) and 15 to be brought instead under §10(b) and thereby nullify the effectiveness of the carefully drawn procedural restrictions on these express actions. 425 U.S. at 210, 96 S.Ct. at 1389. (Footnotes omitted.)

Even if we assume that an implied cause of action does exist under §17(a), for the same reasons expressed by the Court in *Hochfelder* we do not believe that such cause of action can be premised upon negligent wrongdoing. *See Texas Gulf Sulphur Co.*, 401 F.2d at 867–8; *Vacca v. Intra Management Corp.*, 415 F. Supp. 248 (E.D. Penn. 1976); *Thompson v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 401 F. Supp. 111, 115 (W.D. Okla. 1975). In the absence of scienter, judgment for plaintiff cannot be sustained under §17(a) in this case.

Plaintiff next argues that the judgment should be sustained on the ground that Nuveen violated Rule 27 of the National Association of Securities Dealers, Inc.,[12] which provides generally that member-securities dealers must establish, maintain and enforce

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[12]Rule 27 of the National Association of Securities Dealers, Inc., provides in pertinent part:

> Written procedures
>
> (a) Each member shall establish, maintain and enforce written procedures which will enable it to supervise properly the activities of each registered representative and associated person to assure compliance with applicable securities laws, rules, regulations and statements of policy promulgated thereunder and with the rules of this Association.
>
> Responsibility of member
>
> (b) Final responsibility for proper supervision shall rest with the members. The member shall designate a partner, officer or manager in each office of supervisory jurisdiction, including the main office, to carry out the written supervisory procedures. A copy of such procedures shall be kept in each such office.

(Continued on next page)

written procedures for the sale of securities to assure compliance with applicable securities laws. The trial court in its judgment order found that Nuveen violated Rule 27 and had an obligation to establish, maintain and enforce written procedures for the purchase and sale of the notes and other commercial paper, and for the supervision of employees engaged in the purchase and sale of commercial paper. In *Sanders II*, this court saw no need to decide whether plaintiff's losses could fairly be attributable to Nuveen's apparent violation of Rule 27.[13] We must now resolve that issue.

To support a view that violations of the rules of exchanges and associations promulgated in accordance with federal security laws may provide a basis for private damage actions under those laws, plaintiff cites *Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 410 F.2d 135 (7th Cir. 1969), *cert. denied*, 396 U.S. 838, 90 S.Ct. 98, 24 L.Ed.2d 88, and *S.E.C. v. First Securities Co. of Chicago*, 463 F.2d 981 (7th Cir. 1972), *cert. denied sub nom. McKy v. Hochfelder*, 409 U.S. 880, 93 S.Ct. 85, 34 L.Ed.2d 134 (1972). In *Buttrey*, the "know your customer rule" of the New York Stock Exchange was held to be actionable in private suits for damages where the defendant was alleged to have had adverse knowledge about a customer, including knowledge of fraudulent activity, but proceeded to do business with the

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(Continued from previous page)

Written approval

(c) Each member shall be responsible for keeping and preserving appropriate records for carrying out the member's supervisory procedures. Each member shall review and endorse in writing, on an internal record, all transactions and all correspondence of its registered representatives pertaining to the solicitation or execution of any securities transaction.

Review of activities and annual inspection

(d) Each member shall review the activities of each office, which shall include the periodic examination of customer accounts to detect and prevent irregularities or abuses and at least an annual inspection of each office of supervisory jurisdiction.

[13]524 F.2d at 1069 n. 12.

customer in direct violation of specific admonitions in the rule. In *Buttrey*, the court cited *Colonial Realty Corporation v. Bache & Co.*, 358 F.2d 178, 182 (2nd Cir. 1966), *cert. denied*, 385 U.S. 817, 87 S.Ct. 40, 17 L.Ed.2d 56, for the following summary of the principle involved:

> "What emerges is that whether the courts are to imply federal civil liability for violation of exchange or dealer association rules by a member cannot be determined on the simplistic all-or-nothing basis urged by the two parties; rather, the court must look to the nature of the particular rule and its place in the regulatory scheme, with the party urging the implication of a federal liability carrying a considerably heavier burden of persuasion than when the violation is of the statute or an SEC regulation. The case for implication would be strongest when the rule imposes an explicit duty unknown to the common law." *Buttrey*, 410 F.2d at 142.

The court in *Buttrey* noted that the facts alleged were tantamount to fraud and thereby gave rise to a private civil damage action. 410 F.2d at 143.

In *First Securities*, *supra*, subsection c of Rule 27 was involved. That subsection specifically requires each member to review correspondence relative to the solicitation or execution of any security transaction. Contrary to Rule 27(c), the president of First Securities enforced a rule forbidding anyone other than himself to open mail addressed to him. The restriction of access to the mail enabled the president of First Securities to perpetrate a fraud. In finding an implied right to a civil damage action under Rule 27(c), the court stated:

> "We have no doubt that the enforcement of Nay's rule regarding the opening of mail is sufficient without more to constitute a violation of Rule 27. Such violations provide a basis for private damage actions where the rule violated serves to protect the public. *Avern Trust v. Clarke*, 415 F.2d 1238, 1242 (7th Cir. 1969); *Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc., supra*, 410 F.2d at 142–143. First

Securities is properly liable for Nay's fraud because of its violation of Rule 27 of the N.A.S.C." 463 F.2d at 988.

The case at bar is distinguishable from both *First Securities* and *Buttrey* since the district court did not find and our reading of the record in the present case does not support a finding of fraud. Thus, we are unable to accept plaintiff's argument that the district court's judgment may be supported on an implied cause of action under Rule 27.

Furthermore, we are mindful of the admonition in *Colonial* against adopting a simplistic all-or-nothing approach in deciding whether a private civil damage action exists. Thus, although unnecessary to our decision here since fraud is not present, we note the difficulty in deciding the question simply on the basis of fraud without considering at the same time the specific rule or subsection in issue, which may, as here, differ in specificity from the types of rules involved in *Buttrey* and *First Securities* and thus make less appropriate the conclusion that an implied cause of action exists. *Cf. Lange v. H. Hentz & Co.*, 418 F. Supp. 1376 (N.D. Tex. 1976); *Plunkett v. Dominick & Dominick, Inc.*, 414 F. Supp. 885 (D. Conn. 1976).[14]

Plaintiff has one remaining possible basis to support the judgment which was pleaded, in §12(2) of the 1933 Act. Although the trial court made certain incomplete findings of fact pertinent to §12(2) consideration, the court did not reach a conclusion of law

[14]Subsequent to the decisions in *Colonial*, *Buttrey*, and *First Securities*, the Supreme Court considered the question of when a private remedy is implicit in a federal statute. *Cort v. Ash*, 422 U.S. 66, 78, 95 S.Ct. 2080, 45 L.Ed.2d 26; see also *Securities Investor Protection Corp. v. Barbour*, 421 U.S. 412, 95 S.Ct. 1733, 44 L.Ed.2d 263 (1975); *Piper v. Chris-Craft Industries, Inc.*, _____ U.S. _____, _____, 97 S.Ct. 926, 51 L.Ed.2d 124 (1977); *McDaniel v. University of Chicago*, 548 F.2d 689 (7th Cir. 1977). Even if we assume that this same analysis is applicable in deciding whether there exists a civil cause of action for damages for violation of an NASD rule, our conclusion would be unaffected because of the absence of proof of fraud.

as to liability under that section. In *Sanders II*, 524 F.2d at 1069, this court did not rely on §12(2) of the 1933 Act in reaching that decision because the district court had not found any violation of that section.[15] Further, we agreed with Nuveen that the evidence did not indicate that all members of the class had relied on express recommendations by Nuveen. We also noted that plaintiff argued on appeal that the credit reports of the issuer disseminated by Nuveen were prospectuses within the meaning of the Act, but that the district court had made no such finding.[16] For the purposes of the *Sanders II* decision only, we accepted Nuveen's argument that the Lieber, Bleiweis & Company audit was appropriately certified, and that nothing in the audits themselves gave Nuveen any special reason to question their accuracy. Since that latter argument was accepted solely for the purposes of the now vacated decision in *Sanders II* and was in direct conflict with the district court's judgment order, findings of fact and conclusions of law, the prior acceptance of that argument is now no longer valid. Neither the district court nor this court in *Sanders II* passed on the merits of a §12(2) claim as pleaded. *Hartford Life Insurance Co. v. Blincoe*, 255 U.S. 129, 136, 41 S.Ct. 276, 65 L.Ed. 549 (1921); *Connett v. City of Jerseyville*, 110 F.2d 1015, 1029 (7th Cir. 1940). That claim therefore remains open and unresolved.

Regrettably, at this stage in this protracted litigation we cannot resolve the remaining §12(2) issue on the present record. We are compelled to reverse and remand for further proceedings as may be necessary for the district court to make additional findings of fact and reach conclusions of law to support such judgment as the

[15]Nor did the district court conclude that plaintiff failed to establish a prima facie case under §12(2) or that defendants had successfully asserted a defense to that claim. In the absence of such conclusions, and reading the record, findings, and conclusions of law as a whole, we are unable to agree with defendants' suggestion that the district court held against plaintiff on the question of liability under §12(2) and reach our holding upon considering defendants' arguments on the merits.

[16]524 F.2d at 1069.

district court may reach on the possible liability of Nuveen under §12(2) of the 1933 Act.

Defendants' Motion for Summary Reversal is denied.

Reversed and Remanded for further proceedings consistent with this Opinion.

ON MOTION FOR REHEARING EN BANC

Plaintiff-appellee Henry T. Sanders, on May 6, 1977 filed what he labeled a Petition for Rehearing en banc or for Modification of Judgment which raised four issues:

> 1. Appellee reads the opinion as requiring a purchaser of securities to prove reliance in order to recover under §12(2) of the Securities Act of 1933, and argues to the contrary. This court did not in *Sanders II* or in the present case directly address the issue of reliance under §12(2) as the district court had made no findings on the §12(2) allegation of liability. No opinion on that issue was therefore expressed or intended to be expressed.
>
> 2. Appellee reargues that the judgment of the district court should have been affirmed on the ground that Nuveen violated Rule 27 of N.A.S.D. No additional comment is required on that issue.
>
> 3. The appellee also moves that the judgment be modified to provide that each party shall bear its own costs on appeal as being equitable in the circumstances of this case. We agree and the judgment therefore shall be modified accordingly.
>
> 4. Finally, the appellee argues that it did not disclaim the §12(1) theory advanced by the SEC as amicus curiae, and seeks a ruling of this court that it be permitted on remand to amend its complaint to assert claims under §12(1) of the 1933 Act against defendants. This court understood the counsel for plaintiff at oral argument, as mentioned in the

opinion, to disclaim the SEC theory which had not been pleaded or argued. However, the disclaimer of that issue under those circumstances as a basis for affirming the judgment on appeal does not foreclose the plaintiff's proposed amendment to their complaint, a matter we leave to the discretion of the trial judge upon remand.

Subject to the above modification regarding costs, the Motion for Modification is denied.

On consideration of the appellee's "Motion for Rehearing en banc," no judge in active service having requested a vote thereon, the motion is denied.

No. 75-1065

IN THE SUPREME COURT OF THE UNITED STATES

JOHN NUVEEN & CO., INC., et al., *Petitioners*

v.

HENRY T. SANDERS, *Respondent.*

April 19, 1976. On petition for writ of certiorari to the United States Court of Appeals for the Seventh Circuit. Motion of Securities Industry Association for leave to file a brief, as amicus curiae, granted. Motion of Lehman Commercial Paper Incorporated for leave to file a brief, as amicus curiae, granted. Petition for writ of certiorari granted. Judgment vacated and case remanded to the Court of Appeals for further consideration in light of *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 47 L.Ed.2d 668, 96 S.Ct. 1375 (1976). Mr. Justice Stevens took no part in the consideration or decision of this case.

HENRY T. SANDERS, *Plaintiff-Appellee,*

v.

JOHN NUVEEN & CO., INC., et al.,
Defendants-Appellants.

Nos. 74-2047, 75-1260.

United States Court of Appeals,
Seventh Circuit.

Argued June 13, 1975.
Decided Oct. 30, 1975.

Before CLARK, *Associate Justice* (Retired),*
FAIRCHILD, *Chief Judge,* and STEVENS, *Circuit Judge.*

STEVENS, Circuit Judge.

The principal question presented is whether an underwriter of short term commercial paper, who acted in the mistaken but honest belief that financial statements prepared by certified public accountants corrrectly represented the condition of the issuer is liable to its customers for losses sustained as a result of the issuer's default. The district court held the underwriter liable on the theory that it breached a duty to make reasonable inquiries that would have led to the discovery of the issuer's fraud. We affirm.

The plaintiff class consists of 42 purchasers of short term notes issued by Winter & Hirsch, Inc. ("WH"), a finance company that defaulted on its obligations on February 25, 1970. All of the plaintiffs' notes, totaling $1,612,500 in face value, were purchased from the defendant, John Nuveen & Co., Inc. ("Nuveen") during the period between June 30, 1969, and February 10, 1970.

*Tom C. Clark, Associate Justice (Retired) of the United States Supreme Court, was sitting by designation.

Nuveen, whose primary business for many years had been the sale of tax exempt securities, entered the commercial paper business in September of 1968 by acquiring the assets of a commercial paper broker headquartered in Chicago. WH had been one of approximately 40 issuers represented by that broker. Without first making an investigation of the corporate affairs, business, or financial condition of WH, Nuveen began to underwrite and to sell commercial paper issued by WH.

Nuveen operated 17 branch offices located throughout the United States. Its entire sales force, including 172 registered representatives, was authorized to sell commercial paper. The paper which it sold, including the WH notes, was rated "Desirable" by National Credit Office, in a system in which "Prime" was the highest rating and "Desirable" was the second category. The head of Nuveen's commercial paper department testified that the paper handled by Nuveen was sold on the basis "that there should be no question but what the paper will be paid at maturity."

Nuveen customarily prepared a credit report on the issues of commercial paper which it sold; such reports on WH were given to Nuveen's customers. At least some of the reports stated that they contained information derived from a "detailed audit" of WH.

The district court found that Nuveen was an underwriter of WH commercial paper. During the period between September 1968 and February 1970, Nuveen purchased and resold substantially all of WH's short term discount notes.[1] The amount of outstanding indebtedness evidenced by such notes varied from about

[1]The district court found that between September 1, 1968, and February 10, 1970, except for two notes in the face amount of $60,000, Nuveen purchased all the commercial paper issued by WH. Occasionally, as at the time of the default, Nuveen had some of WH paper in its own portfolio.

$1,500,000 to $4,000,000.[2] Nuveen sold WH paper to banks, insurance companies, individuals and firms throughout the United States. They were frequently "rolled over" at maturity; that is, new notes were accepted in payment of outstanding notes when they became due. The conclusion that Nuveen was an underwriter for WH is not challenged.

Nuveen made some investigation of the affairs of WH. It analyzed semiannual financial statements prepared by the certified public accounting firm of Lieber, Bleiweis & Company. Nuveen ascertained that a number of large banks had been extending millions of dollars of credit to WH for many years.[3] In March of 1969 a credit analyst employed by Nuveen spent a day at the offices of WH; he examined records relating to WH's accounts receivable and its collection procedures.

In September of 1969, Investors Diversified Services ("IDS"), through its wholly owned subsidiary, Investors Syndicate of America, Inc., acquired all the stock of Nuveen. The senior vice-president of IDS then became a director of Nuveen and a member of its Executive Committee, with special responsibility for the commercial paper operation. Thereafter, the head of Nuveen's commercial paper department had lunch with the president of

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[2]Thus, the amount of WH commercial paper issued and outstanding in 1968 ranged from a low of $1,915,000 in January to a high of $4,064,500 in April. The amount outstanding at the time of the default in February 1970 was $1,661,500 in face value represented by 56 notes held by 44 different firms or individuals. One note was then held by Nuveen and another holder elected to opt out of the class. Accordingly, the 42 members of the class asserting claims in this litigation held a total of $1,612,500 in WH Notes.

[3]Among those banks, with the amount of the line of credit for each bank, were The First National Bank of Chicago ($1,750,000), Chase Manhattan ($1,750,000), Continental Illinois National Bank and Trust Company of Chicago ($1,500,000), National Bank of Detroit ($1,250,000), Central National Bank of Chicago ($1,250,000), and Harris Trust & Savings Bank ($1,000,000).

WH, noticed that he appeared ill, and decided to conduct a check of WH. Accordingly, Nuveen personnel again reviewed the most recent Lieber, Bleiweis statements, and in mid-January of 1970, letters of inquiry were sent to 10 banks. The responses were either neutral or favorable.

Nuveen never made any request to examine WH's tax returns, its corporate minutes, or its contracts. Nuveen did not meet with any representative of Lieber, Bleiweis and made no request to see any working papers used in the preparation of its semiannual statements.

In January of 1970, two lenders who had heard rumors about the Lieber, Bleiweis audits of WH, insisted that WH retain a new accounting firm to conduct an audit as of January 31, 1970. The new accounting firm was retained on January 12, 1970. Those accountants promptly discovered that no federal income tax return had been filed for the fiscal year ended August 31, 1969; that Lieber, Bleiweis work papers were either not in existence or not available; and that the general ledger of WH could not be reconciled with the August 31, 1969, statement of net worth in the Lieber, Bleiweis audit. In due course, the accountants discovered a $14,000,000 deficiency in the accounts receivable and unrecorded indebtedness of $1,750,000. WH was hopelessly insolvent—a fact which had been concealed by the falsification of records by WH and Lieber, Bleiweis for a period of at least 10 years.[4]

On February 10, 1970, Nuveen first heard the rumors about WH and, as a result of inquiries, also learned that a fresh audit of WH was being made. Nuveen immediately ceased the sale of WH commercial paper and sold none thereafter. The WH notes then outstanding were not paid.

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[4]Ultimately, the principals of WH and Lieber, Bleiweis pleaded guilty in the federal district court to criminal charges and received jail sentences and fines.

On March 12, 1970, plaintiff Henry T. Sanders filed this class action against Nuveen, the corporations directly and indirectly in control of Nuveen,[5] and nine individuals.[6] The complaint as amended principally alleged that the defendant Nuveen violated the federal securities laws by selling WH commercial paper without first making an investigation of WH sufficient to satisfy Nuveen's duty as an underwriter,[7] and the Rules of Fair Practice of the National Association of Securities Dealers, Inc., by failing to establish written procedures for the sale of commercial paper and failing properly to train and supervise its salesmen. The other defendants are alleged to be liable as "controlling persons" of Nuveen.

The district court denied defendants' motion to strike certain critical allegations and then certified to this court the question whether the WH commercial paper was a "security" within the meaning of the Securities Exchange Act of 1934. We answered that question in the affirmative[8] and remanded the case for trial.

[5]The defendants, Investors Diversified Services, Inc., Investors Syndicate of America, Inc., and Alleghany Corporation, are involved only as alleged "controlling persons" with regard to Nuveen. Thus, they can be held liable under §20 of the Securities Exchange Act, 15 U.S.C. §78t, only if Nuveen is first found to be liable.

[6]Two defendants were dismissed by stipulation based on facts not known to the plaintiff at the time of filing suit. All remaining individual plaintiffs were dismissed without prejudice, with the approval of the district judge; in connection with the dismissal IDS guaranteed any judgment which might be entered against Nuveen.

[7]In particular, the amended complaint asserts claims under Sections 12(2) and 17 of the Securities Act of 1933, 15 U.S.C. §§77*l*(2) and 77q; Sections 10(b) and 20 of the Securities Exchange Act of 1934, 15 U.S.C. §§78j(b) and 78t; and Rule 10b-5 of the Securities and Exchange Commission, 17 CFR 240.10b-5.

[8]*Sanders v. Nuveen*, 463 F.2d 1075 (7th Cir. 1972), *cert. denied* 409 U.S. 1009, 93 S.Ct. 443, 34 L.Ed.2d 302 (*Sanders I*). Defendant has asked us to reconsider that holding or, alternatively, to hold that the WH notes sold to banks by Nuveen were not securities even if notes sold to individuals were. Since the findings establish the factual basis for the conclusion expressed in *Sanders I*, the rationale of Judge Sprecher's opinion clearly requires rejection of both of these requests.

After trial the district court made detailed findings of fact and entered judgment for plaintiffs. The court concluded that Nuveen had a duty as an underwriter to make a reasonable investigation of WH and that, in the circumstances of this case, such an investigation would have revealed the fraud. Defendants appeal, primarily contending that Nuveen acted reasonably and did not violate any statutory duty to its customers.

I.

Appeal No. 74-2047

We think appellants are correct in arguing that Nuveen's liability in this case must rest on Rule 10b-5.[9] Section 11 of the Securities Act of 1933 is inapplicable because no registration statement was filed,[10] and we do not rely on §12(2) of that Act because the district court did not find any violation of that section.[11] We also agree with appellants that the evidence does not indicate that all members of the class relied on express recommendations by Nuveen. Moreover, for purposes of decision we accept appellants'

[9]"17 CFR 240.10b-5. Employment of manipulative and deceptive devices.

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operated or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security."

[10]By its terms §11 defines liability for misstatements or omissions in registration statements.

[11]Plaintiff argued on appeal that the credit reports on WH disseminated by Nuveen were prospectuses within the meaning of the Act. The district court made no such finding.

argument that the Lieber, Bleiweis audit was appropriately certified and nothing in the audits themselves gave Nuveen any special reason to question their accuracy.[12] Finally, we deliberately avoid any extended discussion of the broad question whether there is a generally applicable standard of culpability in Rule 10b-5 cases lying somewhere between the extremes of common law fraud on the one hand[13] and mere negligence on the other.[14] We assume the standard may be phrased differently in different circumstances.[15]

In this case, the result is controlled by a few critical facts. Defendant Nuveen was an underwriter of WH commercial paper. Although Nuveen was unaware of the fraud perpetrated by WH and Lieber, Bleiweis, a request to examine federal income tax returns, corporate minute books and accounting work papers—or indeed any one of these sources of information—would have revealed the fraud or at the very least would have revealed deficiencies that would have mandated further inquiry.

Nuveen's status as an underwriter is significant for two reasons. An underwriter's relationship with the issuer gives the underwriter access to facts that are not equally available to members of

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[12]Nor need we decide whether plaintiff's losses could fairly be attributed to Nuveen's apparent violation of Rule 27 of the Rules of the National Association of Securities Dealers, Inc., requiring enforcement of written procedures for the sale of securities.

[13]The rationale of this circuit's selection of the appropriate state statute of limitations to apply to 10b-5 actions rests on the premise that 10b-5 authorizes recovery despite the absence of the kind of scienter necessary to sustain a common law fraud claim. *See Parrent v. Midwest Rug Mills, Inc.*, 455 F.2d 123 (7th Cir. 1972).

[14]*See White v. Abrams*, 495 F.2d 724 (9th Cir. 1974); Bucklo, Scienter and Rule 10b-5, 67 Nw.U.L.Rev. 562 (1972).

[15]Even scholars searching for a generally applicable black letter rule acknowledge the need for specific exceptions based on the nature of a particular business relationship. See *Bucklo, supra.*, n. 14, at 595.

the public who must rely on published information. And the relationship between the underwriter and its customers implicitly involves a favorable recommendation of the issued security. Because the public relies on the integrity,[16] independence and expertise of the underwriter, the underwriter's participation significantly enhances the marketability of the security.[17] And since the underwriter is unquestionably aware of the nature of the public's reliance on his participation in the sale of the issue, the mere fact that he has underwritten it is an implied representation that

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[16]In *Feit v. Leasco Data Processing Corporation*, 332 F. Supp. 544, 581 (E.D.N.Y. 1971), the court noticed that:

> "The average investor probably assumes that some issuers will lie, but he probably has somewhat more confidence in the average level of morality of an underwriter who has established a reputation for fair dealing."

[17]In a case arising under §14 of the 1934 Act, Judge Timbers wrote at length about the special responsibilities of underwriters, stating:

> "The investing public properly relies upon the underwriter to check the accuracy of the statements and the soundness of the offer; when the underwriter does not speak out, the investor reasonably assumes that there are no undisclosed material deficiencies.
>
> * * *
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> "Self-regulation is the mainspring of the federal securities laws. No greater reliance in our self-regulatory system is placed on any single participant in the issuance of securities than upon the underwriter. He is most heavily relied upon to verify published materials because of his expertise in appraising the securities issue and the issuer, and because of his incentive to do so. He is familiar with the process of investigating the business condition of a company and possesses extensive resources for doing so. Since he often has a financial stake in the issue, he has a special motive thoroughly to investigate the issuer's strengths and weaknesses. Prospective investors look to the underwriter—a fact well known to all concerned and especially to the underwriter—to pass on the soundness of the security and the correctness of the registration statement and prospectus." *Chris-Craft Industries, Inc. v. Piper Aircraft Corp.*, 480 F.2d 341, 370 (2d Cir. 1973).

he has met the standards of his profession in his investigation of the issuer.[18]

Nuveen argues that the underwriter's duty of disclosure is limited to "facts which he knows and those which are reasonably ascertainable."[19] That statement of the standard as applied to a broker-dealer would justify reliance on published data. But a greater quantity of information is "reasonably ascertainable" by an underwriter than by a mere broker, and something more than published data must be analyzed if an underwriter is to discharge

[18]Whether reviewing the underwriter's duty to investigate under the standards of §11 applicable to registration statements or under the standards of Rule 10b-5, the following comment by Judge McLean is pertinent:

> "To effectuate the statute's purpose the phrase 'reasonable investigation' must be construed to require more effort on the part of the underwriters than the mere accurate reporting in the prospectus of 'data presented' to them by the company. It should make no difference that this data is elicited by questions addressed to the company officers by the underwriters, or that the underwriters at the time believe that the company's officers are truthful and reliable. In order to make the underwriters' participation in this enterprise of any value to the investors, the underwriters must make some reasonable attempt to verify the data submitted to them. They may not rely solely on the company's officers or on the company's counsel. A prudent man in the management of his own property would not rely on them." *Escott v. BarChris Construction Corporation*, 283 F. Supp. 643, 697 (S.D.N.Y. 1968).

[19]As we understand Nuveen's argument, Nuveen would acknowledge an obligation to comply with the standard applicable to a broker-dealer who had recommended the purchase of a security. That standard was described as follows in *Hanley v. S.E.C.*, 415 F.2d 589, 597 (2d Cir. 1969):

> "In summary, the standards by which the actions of each petitioner must be judged are strict. He cannot recommend a security unless there is an adequate and reasonable basis for such recommendation. He must disclose facts which he knows and those which are reasonably ascertainable. By his recommendations he implies that a reasonable investigation has been made and that his recommendation rests on the conclusions based on such investigation. Where the salesman lacks essential information about a security, he should disclose this as well as the risks which arise from his lack of information."

his duty of investigation. In this case, the district court correctly found that Nuveen's investigation of WH was deficient and that an appropriate investigation would have revealed the fraud.

In reaching this conclusion we have taken into consideration the fact that the security was short term commercial paper rather than stock or long term indebtedness. The nature of this security minimized the investor's interest in the long range prospects of the issuer and therefore would justify a lesser consideration by the underwriter of such matters as growth prospects and dividend policies. On the other hand, the fact that the investor's concern was limited to the issuer's ability to pay its bills in the immediate future enhanced the importance of determining the basic integrity of the issuer's financial statements. Although the underwriter cannot be a guarantor of the soundness of any issue, he may not give it his implied stamp of approval without having a reasonable basis for concluding that the issue is sound.

Nuveen forcefully argues that its reliance on the Lieber, Bleiweis audits was reasonable because the leading banks in the country, which had extended millions of dollars of credit to WH over a period of many years, also relied on the same information (or misinformation). There are two answers to this argument. First, the reasonableness of a bank's credit investigation procedures is not before us and is not to be judged under the standards of the Federal Securities Acts; we are concerned only with the duty of the underwriter to comply with the requirements of statutes and regulations designed to protect the investing public. Second, even if we should assume that the banks are subject to the same standards as an underwriter, the fact that their practices may have been considered acceptable by the banking industry would not convince us that they meet the standards imposed by the relevant statutes and regulations.[20]

[20]We recently quoted the following excerpt from Judge Hand's opinion in The *T. J. Hooper*, 60 F.2d 737, 740 (2d Cir.):

> "Indeed in most cases reasonable prudence is in fact common prudence; but strictly it is never its measure; a whole calling may

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No doubt there are cases in which an issuer may perpetrate a fraud which will escape detection notwithstanding a reasonable investigation by an underwriter. Experience teaches us that fraud can be skillfully hidden. But this was not such a case. The indications of questionable practices by WH were easily accessible to a competent underwriter with a question of fraud in mind. Even though WH was an old established firm with a fine reputation, that fact cannot justify the conclusion that an underwriter's investigation which entirely ignored the possibility of fraud was reasonable. The underwriter is under a duty to make at least some investigation directed at the question whether the ever present possibility of fraud is in fact a reality. The district court correctly concluded that Nuveen breached that duty.

II.

The three remaining defendants are corporations which have controlled Nuveen since September 15, 1969.[21] They are jointly and severally liable for Nuveen's violation unless they "acted in good faith and did not directly or indirectly induce the act or acts constituting the violation . . ." within the meaning of §20 of the Securities and Exchange Act of 1934.[22] The "act" involved here is Nuveen's failure to make a proper investigation of WH.

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> have unduly lagged in the adoption of new and available devices. It never may set its own tests, however persuasive be its usages. Courts must in the end say what is required; there are precautions so imperative that even their universal disregard will not excuse their omission."

See Hochfelder v. Ernst & Ernst, 503 F.2d 1100, 1113 (7 Cir. 1974).

[21]They are Investors Syndicate of America (ISA) which from September 15, 1969, until some time after the events in this case owned 100% of the stock of Nuveen; Investors Diversified Services (IDS), which owns all of the stock of ISA; and Alleghany Corporation, which owns more than 40% of the stock of IDS.

[22]That section provides:

> "§78t. Liabilities of controlling persons (a) Every person who, directly or indirectly, controls any person liable under any provision

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The district court found that, following the acquisition of Nuveen on September 15, 1969, IDS caused its senior vice-president, Kenneth Wahlberg, to become a member of the board of directors of Nuveen, and a member of a three-man executive committee established to conduct and supervise Nuveen's operations. Wahlberg was experienced in buying commercial paper; Richard Frank, the executive vice-president of Nuveen, testified that Nuveen looked to Wahlberg for expert guidance and direction in conducting Nuveen's commercial paper operations.[23] In December, 1969, Wahlberg, as a member of Nuveen's executive committee, reviewed the commercial paper sold by Nuveen and participated in the committee's decision that Nuveen would continue to sell the notes issued by WH. These facts show a direct involvement by Wahlberg in the actual conduct found wrongful here by the underwriting of WH paper without conducting a reasonable investigation.[24] Since he was a senior executive acting on

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of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

(b) It shall be unlawful for any person, directly or indirectly, to do any act or thing which it would be unlawful for such person to do under the provisions of this chapter or any rule or regulation thereunder through or by means of any other person.

(c) It shall be unlawful for any director or officer of, or any owner of any securities issued by, any issuer required to file any document, report, or information under this chapter or any rule or regulation thereunder without just cause to hinder, delay, or obstruct the making or filing of any such document, report, or information." 15 U.S.C. §78t.

[23]Wahlberg also testified that in October, 1969, instructions were given to hire a credit investigator in the commercial paper department as additional personnel Wahlberg felt was needed.

[24]This is a very different situation from that in *Lanza v. Drexel & Co.*, 479 F.2d 1277 (2d Cir. 1973)(en banc). There, a partner in Drexel & Co., a securities dealer with a director of BarChris Construction Co.

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behalf of IDS and ISA, these corporations are liable as "controlling persons."

The situation is rather different as regards Alleghany Corporation. Alleghany is primarily an investor. Although it was in control of IDS by virtue of its 40% stock ownership and because officers and directors of Alleghany acted as officers and directors of IDS, it was never shown that Alleghany took any active part in the management of Nuveen; rather, it delegated this task to IDS. The judgment against Alleghany should therefore be reversed.

III.

Appeal No. 75-1260

After entry of the judgment appealed from in No. 74-2047, the district court heard objections from defendants-appellants on issues relating to particular claims. On January 27, 1975, the district court entered a final order overruling all such objections not previously withdrawn or ruled upon. On February 21, 1975, defendants' notice of appeal on these issues was entered. We deal with these issues individually.

A.

Appellants contend that the district court erred in failing to require the individual members of the plaintiff class to show (a) whether they had received any recommendation or report from

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Officers of BarChris made certain misrepresentations to the plaintiff in arranging a merger of the plaintiff's company into BarChris. Plaintiff sought to hold Coleman liable as a director, and Drexel & Co. liable as his employer. However, Coleman was not present at the meeting where the misrepresentations were made, and he inquired of one of BarChris's officers who affirmatively misled him.

Here, Wahlberg, on behalf of IDS and ISA, was an executive with direct responsibility for the extent of Nuveen's investigation. Although he relied on Nuveen's "fine reputation," he knew what investigations were, or were not, actually being made.

Nuveen on WH; (b) whether each class member's purchase represented a commercial or an investment transaction; and (c) the degree of knowledge which each class member possessed regarding WH at the time of purchase.

The disposition which we have made of the liability issue disposes of the first contention; as an underwriter selling the WH notes, Nuveen made an implied representation that it had reasonable grounds for belief that these notes would be paid at maturity. Of necessity, this "representation" was made to all purchasers from Nuveen. *Cf. Affiliated Ute Citizens v. United States*, 406 U.S. 128, 152–153, 92 S.Ct. 1456, 31 L.Ed.2d 741, rehearing denied 407 U.S. 916, 92 S.Ct. 2430, 32 L.Ed.2d 692 and 408 U.S. 931, 92 S.Ct. 2478, 33 L.Ed.2d 345 (1972). Since it can fairly be inferred that no member of the plaintiff class would have bought the notes had he known, as Nuveen could easily have discovered, that WH's financial records were fraudulent, the representation was material and provides the basis for recovery by the entire class.

The appellants' contention that each of the banks which was a member of the plaintiff class should have been required to show that it acquired the note or notes in question as a result of an investment rather than a commercial transaction is also without merit. Plaintiffs have shown that these notes were acquired from Nuveen, and not a part of a direct loan transaction with WH. Since the notes were marketed as securities, see *Sanders I, supra*, at 1080, this is sufficient to bring the bank within the protection of the Securities Act. *Cf. Lehigh Valley Trust Co. v. Central National Bank of Jacksonville*, 409 F.2d 989, 992–993 (5th Cir. 1969).

Nor is it material, short of a showing of actual knowledge of the fraud, what knowledge any plaintiff had about WH. The unsophisticated and unwary are not the only beneficiaries of the federal securities laws. See, e.g., *Hill York Corp. v. American International Franchise, Inc.*, 448 F.2d 680 (5th Cir. 1971); *S.E.C. v.*

Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied sub nom. Kline v. S.E.C.*, 394 U.S. 976, 89 S.Ct 1454, 22 L.Ed.2d 756 (1969). There has not been (save in the special case of National Stock Yards National Bank, discussed below) any suggestion that any plaintiff actually knew of the fraud at the time it purchased the securities.[25]

B.

The defendants object to recovery by National Stock Yards National Bank and Capitol Bank of Springfield on the grounds that (1) both are *in pari delicto* with Nuveen, and (2) as to National, it reacquired the notes after it had actual notice of the fraud. Neither of these objections is well taken.

National and Capitol purchased notes from Nuveen which they then resold to correspondent banks. However, it is clear that National and Capitol were acting as agents for their correspondent banks, and not as underwriters as was Nuveen.[26] Thus, they did not share Nuveen's duty to investigate and cannot be considered to be *in pari delicto* with Nuveen.[27]

Appellants also contend that National should be barred from recovering because it repurchased the notes after it had actual knowledge of the fraud.

National has filed a claim in this case as the holder of seven WH notes. National purchased those notes between November

[25]Since no showing of individual reliance or general ignorance of WH was required, the district court did not abuse its discretion in denying defendants' motion to serve interrogatories on certain members of the plaintiff class after judgment on the common issues.

[26]National and Capitol made no "public distributions," they did not solicit orders for these notes, and they received no compensation for their services in purchasing them.

[27]Because we deem the *in pari delicto* issue to be meritless on the facts, we do not reach the question whether it was, in the circumstances, raised too late to be considered. Although the issue of *in pari delicto* goes to the question of liability, it was not an issue common to all members of the class.

1969 and January 1970 as agent for seven smaller banks for which it acted as correspondent. National paid Nuveen for the notes and either debited the accounts of the smaller banks for the amounts in question or was paid by them. National retained the notes for safekeeping. After being notified of the problem with WH, National repurchased the notes from its correspondent banks.

Appellants contend that National's repurchase of the notes after it had knowledge of the fraud bars it from recovery, apparently on the theory that any loss which National incurred was a result not of Nuveen's misconduct, but of National's knowing assumption of risk. If National had made its purchase from Nuveen despite knowledge of material adverse facts, the contention would have some force. But here National merely acts to protect the seven correspondent banks from loss on the notes which National had chosen for them. That action did not enlarge Nuveen's potential liability, but merely had the effect of substituting National for the seven banks as the injured party. To hold that National could not recover in this situation would be to frustrate the purpose of the securities acts to protect innocent investors—here, the seven correspondent banks—because it would tend to deter such repurchase by intermediate banks. Appellants have also argued, in attempting to put forward a defense of *in pari delicto*, that National had a legal duty to reimburse the correspondent banks. While we have found that National was not an underwriter, this does not foreclose the possibility that National was liable to its correspondents on some other basis. In that case, of course, National's loss would have been the same whether it voluntarily repaid the correspondents, or was forced to do so by legal action. In either case, National's loss was a direct result of Nuveen's sale of the notes without a reasonable basis to believe that they would be paid when due.[28]

[28]Appellants also suggest that National cannot recover because it is not properly a member of the class, since it did not own the notes on February 23, 1970. However, National was always included in the list of

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C.

Appellants object to the claim of Dimmy Andrews on the ground that he had previously opted out of the action. The record shows that Andrews wrote a letter opting out; that he "intended" to send it to the court, although he could not remember whether it was actually mailed; that a carbon copy of the letter was sent to and received by Nuveen, but that there was no record of the letter ever having been received by the court. There was also some evidence to show that Andrews decided to opt out of the advice of a Mr. Stuart, an employee of Nuveen. On these facts, the district court found that Andrews had not effectively opted out of the class.

With some misgivings, we conclude that the district court did not abuse its discretion in so holding. Courts have been flexible in recognizing elections to be excluded from a class which were communicated to the court, although not in the proper form. *In re Four Seasons Securities Law Litigation*, 493 F.2d 1288 (10th Cir. 1974); *Bonner v. Texas City Independent School Dist. of Texas*, 305 F. Supp. 600 (S.D. Tex. 1969). However, in this case, no communication was actually received by the court until after the adjudication on the merits. Thus, while the question is a close one in view of the obvious dangers of "one-way intervention," we cannot say that the district court exceeded its broad discretion.

IV.

Appellants argue that the award of prejudgment interest was erroneous because the trial court failed properly to weigh the

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class members and received all notices. Appellants did not raise the point until after the decision on the merits, so there was no opportunity to correct what may have been a self-contradictory class description. And in any case, exclusion of National from the class at this point would not defeat a separate action by National since the statute of limitations has been tolled during the pendency of the class action. *American Pipe & Construction Co. v. Utah*, 414 U.S. 538, 94 S.Ct. 756, 38 L.Ed.2d 713.

equities between the plaintiffs and defendants. It is true that the award of prejudgment interest is responsive to considerations of fairness. *Blau v. Lehman*, 368 U.S. 403, 414, 82 S.Ct. 451, 7 L.Ed.2d 403. But the imposition of prejudgment interest is in its origin a form of compensation, not a penalty. As the Supreme Court said in *Rodgers v. United States*, 332 U.S. 371, 373, 68 S.Ct. 5, 7, 92 L.Ed. 3:

> As our prior cases show, a persuasive consideration in determining whether such obligations shall bear interest is the relative equities between the beneficiaries of the obligation and those upon whom it has been imposed. And this Court has generally weighed these relative qualities in accordance with historic judicial principle that one for whose financial advantage an obligation was assumed or imposed, and who has suffered actual money damages by another's breach of that obligation, should be fairly compensated for the loss thereby sustained.

Thus, if a defendant has deprived the plaintiff of a specific sum of money, he has also deprived the plaintiff of the interest which the money would have earned in the absence of defendant's breach of duty; unless the plaintiff is paid interest for the entire time that he is deprived of the use of his money, he will not receive full compensation.

Nevertheless, for various reasons it may be inequitable to impose such an extra payment on the defendant. For example, if final judgment is unreasonably delayed due to the actions of the plaintiff, interest should be suspended for the period of the delay. Or, if the interest would in effect act as a penalty on a relatively innocent defendant, the court has discretion to refuse to award interest. *Compare Blau v. Lehman*, 368 U.S. 403, 82 S.Ct. 451, with *Norte & Co. v. Huffines*, 416 F.2d 1189 (2d Cir. 1969), *cert. denied Muscat v. Norte & Co.*, 397 U.S. 989, 90 S.Ct. 1121, 25 L.Ed.2d 396.

In this case, the award of interest was proper. Plaintiffs suffered the loss of use of the money which they had invested in WH notes (except for the portion recovered from the WH Liquidating Trust). The extended delay between the loss and final judgment was not caused by any dilatory tactics by the plaintiffs. And there are no countervailing equitable considerations making the award unfair to Nuveen. It is true that Nuveen had no actual knowledge of the fraud, but we have nonetheless held that Nuveen is responsible for serious omissions in the performance of its statutory duty as an underwriter. Although Nuveen did not receive the money which the plaintiffs lost, recovery is predicated on compensation of the victim, not on a surrender of unjustified profits. Nuveen aided in setting up the liquidating trust which gave partial recovery to the plaintiffs, but Nuveen has had the benefit of the trust in that all payments from the trust have reduced Nuveen's liability. The district court was thus correct in awarding prejudgment interest.

The rate allowed, however, was incorrect. In line with the underlying principle of compensation, the rate allowed should be chosen to reflect the rate which the money would have earned for the plaintiffs had defendants not breached their duty. The theory of this case is that if Nuveen had not breached its duty, plaintiffs would never have purchased the notes in question. Thus, the rate of interest on the WH notes cannot be a correct gauge of what the plaintiff's money would otherwise have earned. That rate is wholly speculative, and therefore the legal judgment rate should have been used.

For the reasons explained above, the judgment of the district court is affirmed in part, reversed in part, and the cause is remanded to the district court for entry of judgment consistent with this opinion. The costs of this appeal are to be taxed in full against all defendants-appellants except Alleghany Corporation.

HENRY T. SANDERS, *Plaintiff-Appellant,*

v.

JOHN NUVEEN & CO., INC., *Defendants-Appellees.*

HENRY T. SANDERS, *Plaintiff-Appellee,*

v.

JOHN NUVEEN & CO., INC., *Defendants-Appellants.*

Nos. 71-1163, 71-1164

United States Court of Appeals,
Seventh Circuit.

Argued Jan. 26, 1972.
Decided June 9, 1972.

Before HASTINGS, Senior Circuit Judge,
and KILEY and SPRECHER, Circuit Judges.

This appeal raises two principal issues: (1) whether promissory notes with a maturity not exceeding nine months but offered to the public as an investment are "securities" within the definition of the Securities Exchange Act of 1934 and (2) whether the representative of an antagonistic class can properly intervene and assume representation of the plaintiff class without notice to the members of that class?

Plaintiff, Henry T. Sanders, filed his complaint on March 12, 1970, against John Nuveen & Co., Inc., a broker-dealer in securities, one of its registered representatives, and its directors and controlling persons. The complaint charged defendants with a scheme and artifice to defraud plaintiff and others in his class by selling to them short-term commercial paper issued by Winter &

Hirsch, Inc. but owned by Nuveen. Plaintiff's claim was based on the Securities Act of 1933, 15 U.S.C. §77a, the Securities and Exchange Act of 1934, 15 U.S.C. §78a, Rule 10b-5, 17 C.F.R. 240.10b-5, and the Rules of Fair Practice of the National Association of Securities Dealers.

On May 18, 1970, the defendants moved to strike certain allegations of the complaint and expressly attacked the class-action aspects of the complaint. They also challenged the jurisdiction of the court under the 1934 Act on the ground that the short-term commercial paper involved was not a "security." The district court denied the motion to strike on October 8, 1970.

On October 19, 1970, the plaintiff served on defendants his motion, to be presented to the court on November 2, requesting that a notice be sent to the class represented by plaintiff as provided in Rule 23(c)(2) of the Federal Rules of Civil Procedure. The class suggested was "all persons who were purchasers of short-term commercial paper which was issued by Winter & Hirsch, Incorporated, and sold by John Nuveen & Co., Inc."

On October 29, The First National Bank of Chicago and the Harris Trust and Savings Bank sought leave to intervene on their own behalf and "on behalf of certain creditors of Winter & Hirsch, Incorporated."

The motion to intervene stated that on March 11, 1970 (one day prior to the filing of plaintiff's suit), the creditors of Winter & Hirsch had met and had elected an informal creditors' committee. The creditors' committee, working with the management of Winter & Hirsch, had negotiated with Mercantile Financial Corp. a purchase agreement relating to substantially all of Winter & Hirsch's loan receivables; the agreement required certain waivers by holders of long-term debt obligations. The motion also stated that the creditors' committee had developed a

liquidating trust to become effective upon the execution and delivery of a "Consent and Agreement" by all the lenders of funds to Winter & Hirsch, including plaintiff.

At the same time that they sought to intervene, the two banks also moved that the district court enter an order pursuant to Rule 23(d) directing the plaintiff to execute a "Consent and Agreement" on a stipulation by all parties that its execution would "not constitute a dismissal or compromise under Federal Rule 23(e)."

The banks' motions were not accompanied by any pleadings in the Rule 7(a) sense of complaints or answers, or by documents seeking to adopt pleadings already on file.

Plaintiff's counsel were notified by telephone the night before that the banks were going to appear before the district judge on October 29; counsel were given copies of the motions at 10 a.m. on the 29th as court convened. The court continued the matter to 1:45 p.m., at which time the plaintiff filed written objections to the motions. The court heard argument by the parties but no evidence in the afternoon, at which time the court requested the parties to attempt to agree on an order. The banks delivered a proposed form of order to plaintiff's counsel at 4 p.m. and advised them that they would reappear in court at 4:30. Plaintiff's counsel replied that they would need some time to read the proposed order and confer with their client. They appeared at the courtroom at 4:50 to learn that the judge had entered an order at 4:35 and left the bench. The order permitted the banks to intervene and directed the plaintiff to sign the stipulation and consent by 5 p.m. or the class aspects of the complaint would be stricken. The intervention was allowed on behalf of creditors including all members of the class which plaintiff sought to represent.

The plaintiff filed a motion to vacate the October 29 order, which motion was denied on November 5, 1970. The court's

reason was "the plaintiff's expressed opposition to all members of the class by refusing to join in a compromise that all of them have agreed to enter into." On its own motion, the court found that "there may be a class described in the cause without counsel," whereby he ordered that "said cause . . . proceed as an individual complaint."

On November 17, 1970, the district judge certified pursuant to 28 U.S.C. §1292(b) the questions (1) whether it was error to permit the banks to intervene, (2) whether it was error to find that the plaintiff did not represent the class and (3) whether it was error to strike the class aspects of the complaint. On the motion of defendants, the court on the following day amended its prior order denying defendants' motion to strike, to certify another question under 28 U.S.C. §1292(b): whether the commercial paper upon which the complaint is predicated is a "security" as defined in section 3(a)(10) of the Securities Exchange Act of 1934.

This court granted leave to appeal on all four questions on December 21, 1970.

We consider first the threshold question of whether a security under the 1934 Act is involved.

I.

Federal securities legislation enacted for the purpose of avoiding frauds is to be construed "not technically and restrictively, but flexibly to effectuate its remedial purposes." *S.E.C. v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195, 84 S.Ct. 275, 285, 11 L.Ed.2d 237 (1963).

Particularly, the definition of a security "embodies a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who

seek the use of the money of others on the promise of profits." *S.E.C. v. W.J. Howey Co.*, 328 U.S. 293, 299, 66 S.Ct. 1100, 1103, 90 L.Ed. 1244 (1946). "[I]n searching for the meaning and scope of the word 'security' in the [Securities Exchange] Act [of 1934], form should be disregarded for substance and the emphasis should be on economic reality." *Tcherepnin v. Knight*, 389 U.S. 332, 336, 88 S.Ct. 548, 553, 19 L.Ed.2d 564 (1967).

The Supreme Court has sanctioned, in interpreting the definition of a security in the 1934 act, recourse to the definitions of security in the Securities Act of 1933 (*Tcherepnin* at 335–336, 338, 88 S.Ct. 548) and in the "companion legislative enactments." *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 92 S.Ct. 1456, 31 L.Ed.2d 741 (1972).

An examination of the six basic federal securities acts is relevant and revealing.

The Securities Act of 1933,[1] the Trust Indenture Act of 1939,[2] the Investment Company Act of 1940,[3] and the Investment Advisers Act of 1940,[4] all define a security as follows: "The term "security" means any note, . . . evidence of indebtedness, . . . investment contract, . . . or, in general, any interest or instrument commonly known as a 'security'. . . ."[5] The Public Utility Holding Company Act of 1935[6] definition differs slightly: " 'Security'

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[1]Section 2(1). 15 U.S.C. §77(b)(1).

[2]Section 303(1). 15 U.S.C. §77ccc(1).

[3]Section 2(a)(36), 15 U.S.C. §80a-2(a)(36).

[4]Section 202(a)(18). 15 U.S.C. §80b-2(a)(18).

[5]Mr. Justice Blackmun, in commenting upon the language of Rule 10b-5 said that proscriptions of the securities laws, by "repeated use of the word 'any' are obviously meant to be inclusive." *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 92 S.Ct. 1456, 1471, 31 L.Ed.2d 741 (1972).

[6]Section 2(a)(16). 15 U.S.C. §79(b)(a)(16).

means any note, . . . investment contract, . . . or, in general, any instrument commonly known as a 'security' . . . ."[7]

[1] In none of these five acts does there appear any language limiting in any way the broad definitions of security or of "note," "evidence of indebtedness," "investment contract" or "instrument commonly known as a security." Therefore, *any* note, regardless of its nature, terms or conditions, is fully subject to whatever antifraud provisions are included in the five acts.

Only in the Securities Exchange Act of 1934 is there an exception to the broad definition of a security; it reads:[8]

> "The term 'security' means any note, . . . investment contract, . . . or in general, any instrument commonly known as a 'security'; . . . but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited."

Therefore only in the 1934 Act is a note with a maturity not exceeding nine months withdrawn from the application of the antifraud provisions of the act, section 10(b) and Rule 10b-5. Since the same note is subject to the antifraud provisions of all the other securities acts, it becomes important to determine just what Congress intended to be exempt from the operation of the 1934 Act.

Although all notes are subject to the antifraud provisions of the other acts, some of those acts exempt short-term commercial

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[7]In *Tcherepnin v. Knight*, 389 U.S. 332, 344, 88 S.Ct. 548, 19 L.Ed.2d 564 (1967), the Supreme Court found no "controlling significance" in the fact that the term "evidence of indebtedness," which was included in the 1933 Act, was omitted from the 1934 Act.

[8]Section 3(a)(10). 15 U.S.C. §78c(a)(10).

paper from registration or other requirements.[9] Plaintiff urges that the meaning given to short-term obligation in other securities legislation, particularly the 1933 Act, be applied to the definition found in the 1934 Act. The 1933 Act exempts from registration,[10] but not from antifraud sanctions,[11] "[a]ny note, draft, bill of exchange, or banker's acceptance which arises out of a current transaction or the proceeds of which have been or are to be used for current transactions," and which has a maturity not exceeding nine months.

The Securities and Exchange Commission has interpreted the 1933 Act's exemption of short-term commercial paper as embodying four requirements:[12]

> "The legislative history of the Act makes clear that Section 3(a)(3) applies only to (1) prime quality negotiable commercial paper (2) of a type not ordinarily purchased by the general public, that is (3) paper issued to facilitate well recognized types of current operational business requirements and (4) of a type eligible for discounting by Federal Reserve banks."

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[9]*Tcherepnin v. Knight*, 389 U.S. 332, 88 S.Ct. 548, 19 L.Ed. 2d 564 (1967) (withdrawable capital shares of savings and loan association subject to Rule 10b-5 although exempt from registration). *See also* Opinion of Director of Trading & Exchange Division of S.E.C., Release No. IA-40, 11 F.R. 10997 (1945).

[10]Section 3(a)(3). 15 U.S.C. §77c(a)(3).

[11]Section 17(c). 15 U.S.C. §77q(c).

[12]Release No. 33-4412, 17 C.F.R. §231.4412(1961) (numerals added). The release emphasized the prime quality of the paper intended to be exempted and stated that the exempted items are "composed of assets easily convertible into cash and are comparable to liquid inventories of an industrial or mercantile company." During the hearings on the 1933 act, commercial paper discountable by Federal Reserve banks was described as having "a record of safety only second to Government bonds" and as being the basis of our currency. Hearings on S. 875 Before the Senate Comm. on Banking and Currency, 73rd Cong., 1st Sess. at 94, 95 (1933). It is significant that section 3(a)(10) of the 1934 act exempts "currency" from the definition of security. 15 U.S.C. §78c(a)(10).

Although no evidence has been heard in this case, the record shows that the commercial paper purchased by the plaintiff was dated January 30, 1970, and that "Winter & Hirsch was engaged in the business of making loans until in or about February 1970, when it advised its creditors of its precarious financial condition and ceased to make any further payments on any of its obligations for borrowed money." At that time it had assets of $12.5 million and liabilities of more than $36 million. Thus, because of the company's insolvency, it seems highly unlikely that the paper purchased by the plaintiff and members of his class is either prime quality or issued to facilitate current transactions or eligible for discounting by Federal Reserve banks.

The record further shows that the commercial paper purchased by the plaintiff was "placed through John Nuveen & Co." and bought by 42 purchasers, including the plaintiff, in the aggregate face amount of $1,661,500. The paper was therefore obviously offered and sold to the general public; indeed, it was characterized in the issuer's financial statements as "short term open market" paper.[13] The notes fail to meet any of the S.E.C.'s four requirements for exemption.

If, as the Supreme Court has admonished, "form should be disregarded for substance" and economic reality emphasized, it is reasonably clear that plaintiff and his class purchased the kind of "security" in regard to which the securities acts were intended to offer protection against fraud, misrepresentation and non-disclosure.[14] Five of those acts expressly did so. We believe Congress

[13]H.R.Rep. No. 85, 73rd Cong., 1st Sess., 15 (1933) stated in discussing the bill, which became the Securities Act of 1933, "Paragraph (3) exempts short-term paper of the type available for discount at a Federal Reserve bank and of a type which rarely is bought by private investors."

[14]Forty of the purchasers invested from $3,000 to $100,000 and the other two invested $150,000 and $205,000. In *Tcherepnin*, the Supreme Court, noting that small investors were involved, said (389 U.S. at 345, 88 S.Ct. at 558): "Policy considerations lead us to conclude that these petitioners are entitled to the investor protections afforded by the Securities Exchange Act."

intended to protect against fraud the purchasers of securities such as those involved hereunder the 1934 Act as well.[15]

The court in *Anderson v. Francis I. duPont & Co.*, 291 F.Supp. 705, 708–709 (D.Minn. 1968), reached the same conclusion. Promissory notes of less than nine months' maturity were given in exchange for investments in defendant's commodities market scheme. The court held the 1934 Act applicable to the notes.

Our conclusion is further supported by Congress' characterization of short-term commercial paper in exempting it from certain provisions (but not anti-fraud provisions) of two of the other securities acts. Certain provisions of the Public Utility Holding Company Act of 1935 do not apply to a note or draft with a maturity not exceeding nine months, provided that it "is not part of a public offering" and aggregates not more than 5 percent of the other securities of the company.[16] The Investment Company Act of 1940 defines "short-term paper" as paper with a maturity not exceeding nine months "and such other classes of *securities, of a commercial rather than investment character*, as the Commission may designate by rules and regulations."[17]

In other words, when Congress spoke of notes with a maturity not exceeding nine months, it meant commercial paper, not investment securities.[18] When a prospective borrower approaches a bank for a loan and gives his note in consideration for it, the bank has purchased commercial paper. But a person who seeks to

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[15]Professor Loss equates the 1933 Act meaning of security with that of the 1934 Act to some extent: "Short-term notes of the type which are exempted from registration under the Securities Act by 3(a)(3) are excluded from the definition of 'security' in the Exchange Act." 2 Loss, Securities Regulation 796 (1961).

[16]Section 6(b). 15 U.S.C. §79f(b).

[17]Section 2(a)(38). 15 U.S.C. §80a-2(a)(38) (emphasis added)

[18]Although some of the paper placed through Nuveen went to banks, the large majority of purchasers were individuals.

invest his money and receives a note in return for it has not purchased commercial paper in the usual sense. He has purchased a security investment. *Cf. City National Bank v. Vanderboom*, 290 F.Supp. 592, 608 (W.D.Ark., 1968), *aff'd*, 422 F.2d 221 (8th Cir.), *cert. denied*, 399 U.S. 905, 90 S.Ct. 2196, 26 L.Ed.2d 560 (1970).

Although further evidence may be necessary to determine the issue, the allegations of the complaint together with additional information in the record on appeal indicate a strong possibility that Nuveen's arrangements with the plaintiff and with the members of plaintiff's class also constitute investment contracts. Apparently, Nuveen purchased the Winter & Hirsch paper at a discount and resold it to the 42 purchasers at a different rate of discount in order to realize a profit. At least in the plaintiff's case (and evidence would be necessary to determine in how many other cases), the use of plaintiff's funds for the short-term notes was a temporary arrangement "in lieu of tax exempt municipal bonds and . . . the money so invested would be available for purchase of tax exempt bonds at an early date."

It seems likely that the arrangements between Nuveen and plaintiff constituted "the placing of capital or laying out of money in a way intended to secure income or profit from its employment". *S.E.C. v. W.J. Howey Co.*, 328 U.S. 293, 298, 66 S.Ct. 1100, 1102, 90 L.Ed. 1244 (1946). *See also* 1 Loss, *Securities Regulation* 489–91 (1961); *Anderson v. Francis I. duPont & Co.*, 291 F.Supp. 705, 708 (D.Minn. 1968).[19]

However, in view of our interpretation that the instruments involved here are securities since they are notes not covered by the

[19]Professor Bromberg has noted, "Even if short term notes are effectively excluded from the definition of security, their use in connection with an investment contract or other transaction constituting a security does not immunize the transaction from the antifraud rules." Bromberg, *Securities Law, Fraud*, SEC Rule 10b-5, §4.6 (321) (1971).

exemption, we do not need to determine whether as a matter of fact the arrangements between the parties also constituted investment contracts.

II.

The remaining three issues certified for determination can be considered together: whether the allowance of the banks' intervention was proper and whether the district court erred in finding that the plaintiff did not represent the class and in striking the class allegations from the complaint.

The record discloses that the two intervening banks are holders of "short term senior debt" as banks extending lines of credit, First National Bank of Chicago in the amount of $1,750,000 and Harris Trust and Savings Bank in the amount of $1,000,000. As such, neither bank would come within the class suggested by the plaintiff, namely, all persons who were purchasers of short-term commercial paper which was issued by Winter & Hirsch and sold by John Nuveen & Co. The plaintiff has alleged in addition, and the banks have not denied, that each bank is also the holder or owner of substantial amounts of long-term debt of Winter & Hirsch, which is described in the liquidating trust agreement as "junior subordinated debt."

Since it is acknowledged by all parties that Winter & Hirsch is insolvent and unable to pay its debts as they mature, it is reasonably certain that the creditors will eventually receive less than the amounts which they are owed. It follows that any advantage obtained by one class of creditors will cause other classes of creditors to be disadvantaged. The two intervening banks, as members of at least two classes of creditors other than the class represented by the plaintiff, are *per se* antagonistic to the plaintiff's class. It is obvious that the banks can neither represent the plaintiff's class nor strengthen the representation of plaintiff's class by intervening.

The portions of Rule 23(d) pertaining to intervention in class actions are intended to strengthen the adequacy of representation of the class.[20] The Advisory Committee's Note to Rule 23 emphasizes, "Subdivision (d) is concerned with the fair and efficient conduct of the action" through supplementary notice to members of the class and by strengthening the class where necessary.[21]

Since the district judge did not provide for any notice to the plaintiff class, it was clearly improper for him to permit the two banks, with their conflicting and antagonistic interests, "to intervene herein, on their own behalf and on behalf of those creditors of Winter & Hirsch, Incorporated set forth in Exhibit B to the Motion to Intervene." That exhibit listed, among others, the members of plaintiff's suggested class: all persons who were purchasers of short-term commercial paper which was issued by Winter & Hirsch and sold by Nuveen. The effect of such intervention was to weaken the plaintiff class and possibly to strip from it advantages which it held against other classes of creditors, in-

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[20]Fed.R.Civ.P.23(d): "In the conduct of actions to which this rule applies, the court may make appropriate orders: . . . (2) requiring, for the protection of the members of the class or otherwise for the fair conduct of the action, that notice be given in such manner as the court may direct to some or all of the members of any step in the action, or of the proposed extent of the judgment, or of the opportunity of members to signify whether they consider the representation fair and adequate, to intervene and present claims or defenses, or otherwise to come into the action; (3) imposing conditions on the representative parties or on intervenors. . . ."

[21]Advisory Committee Note to Rule 23 states in part: "Subdivision (d)(2) sets out a non-exhaustive list of possible occasions for orders requiring notice to the class. . . . [The] mandatory notice pursuant to subdivision (c)(2), together with any discretionary notice which the court may find it advisable to give under subdivision (d)(2), is designed to fulfill requirements of due process to which the class action procedure is of course subject. . . . Subdivision (d)(3) reflects the possibility of conditioning the maintenance of a class action, *e.g.*, on the strengthening of the representation . . .; and recognizes that the imposition of conditions on intervenors may be required for the proper and efficient conduct of the action."

cluding the classes of which the two intervening banks are members. The attempt to include some protective language in the intervention order did not alter the fact that once antagonistic parties purported to represent the class, the plaintiff's cause virtually collapsed. No intervention could be accomplished without prior full and fair notice to the members of plaintiff's class and, of course, such notice could not be given until the court determined whether plaintiff's suggested class fulfilled the requirements of Rule 23(a) and (b)(3).[22]

If in fact the banks had procured the "consent and agreement" of all the members of plaintiff's class other than plaintiff, such consent and agreement was meaningless within the context of this cause of action unless procured after full and fair notice and disclosure to the members of the class, under the supervision of the court, of their possible rights in this cause, of the conflicting interests of other classes of creditors, including the banks, and of the surrender of certain rights by consenting and agreeing to the liquidating trust arrangement. The purpose of the mandatory notice and disclosure requirements of Rule 23(c)(2) is to advise all class members of their rights and privileges under the close supervision of the court.

This is not to say that the banks could not intervene under any circumstances. Once the court has determined whether the plaintiff's suggested class satisfies the requirements of Rule 23(a) and (b)(3), and once members are notified under Rule 23(c)(2), the banks may seek to intervene under Rule 24(a)(2). They would petition not as representatives of the plaintiff's class, but as applicants who claim "an interest relating to the property or transaction which is the subject of the action and [are] so situated that the disposition of the action may as a practical matter impair or impede [their] ability to protect that interest. . . ." At that point,

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[22] *Hohmann v. Packard Instrument Co.*, 399 F.2d 711 (7th Cir. 1968).

the court may determine that the members of plaintiff's class are entitled to supplementary notice under Rule 23(d)(2).[23]

If the banks seek to intervene under those circumstances, Rule 24(c) and sound judicial administration require that their motion to intervene "shall state the grounds therefore and shall be accompanied by a pleading setting forth the claim or defense for which intervention is sought." The pleading should be one of those described in Fed.R.Civ.P. 7(a) so that all parties understand the position, claims and nature of relief sought by the prospective intervenors.

Once the due process requirements of Rule 23 are satisfied by full and fair notice to all members of any class or classes or subclass or subclasses determined by the court, the court may then "make appropriate orders . . . determining the course of proceedings."[24]

The basic error in these proceedings was permitting two members of antagonistic classes to intervene on behalf of another (plaintiff's) class and not only to purport to take over plaintiff's case but in effect to introduce an entirely different cause of action in which all parties but plaintiff had previously "consented" without notice and disclosure under court supervision of their rights and options. The error was compounded by attempting to coerce the plaintiff to add his consent.

In No. 71-1163 we reverse the orders which allow intervention, which find the plaintiff not representative of the class alleged in

[23]In order to expedite the proceedings, the court may determine that it is feasible to combine the mandatory notice under Rule 23(c)(2) with the discretionary notice under 23(d)(2).

[24]Fed.R.Civ.P. 23(d)(1). It should also be noted that not only may a class be divided into subclasses if that course seems advisable to the trial court (Rule 23(c)(4)), but also that any order fixing classes or subclasses "may be conditional, and may be altered or amended before the decision on the merits" (Rule 23(c)(1)).

the complaint and which strike allegations in the complaint as to class action. In No. 71-1164, we affirm the order denying the motion to strike certain allegations of the complaint, because the commercial paper on which the plaintiff predicated his claim for relief is a "security" under the Securities Exchange Act of 1934. The case is remanded for further proceedings consistent with this opinion.

Supreme Court, U
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MICHAEL RODAK, JR.,

No. 80-299

In the Supreme Court of the United States

OCTOBER TERM, 1980

JOHN NUVEEN & CO., INC., a corporation, INVESTORS SYNDICATE OF AMERICA, INC., a corporation, and INVESTORS DIVERSIFIED SERVICES, INC., a corporation,

Petitioners,

vs.

HENRY T. SANDERS, et al.,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR RESPONDENTS IN OPPOSITION

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QUESTIONS PRESENTED

1. Whether an underwriter-seller of securities is liable to its purchasers under §12(2) of the Securities Act of 1933 for its negligence in failing to discover that the securities were issued fraudulently, and for material misrepresentations and omissions concerning those securities in prospectuses disseminated by it and in oral statements made by its salesmen.

2. Whether an underwriter who sells to the public fraudulently issued, unregistered securities which are not exempt from registration under the Securities Act of 1933 is liable under §12(1) of the Act to the purchasers of those securities.

PARTIES TO THE PROCEEDINGS

This class action was brought by Henry T. Sanders, on behalf of himself and all other purchasers from John Nuveen & Co., Inc. ("Nuveen") of notes issued and dishonored by Winter & Hirsch, Inc. ("WH"), a now defunct Illinois finance company. Defendants incorrectly state that subsequent to the entry of the initial judgment this action proceeded on a multiple plaintiff basis, with each plaintiff participating individually, through counsel. Petition ("Pet."), p. ii. This action always has proceeded as a class action. See Order Certifying Class, App. I, 42;[1]

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[1] In the Seventh Circuit defendants filed a four-volume Appendix. References herein to portions of the record reproduced in that Appendix and not in the Appendix to the instant Petition shall be prefixed by the symbol "App.", followed by the Appendix volume number and page reference. References to exhibits admitted in evidence but not included in any appendix shall be made by reference to the exhibit numbers. References to the Appendix filed by defendants shall be designated "A", followed by the page reference.

Order Approving Class Claims, A. 18; Judgment Order, A. 20. Plaintiffs' attorneys have acted as class counsel since entry of the order designating the class.

Defendants correctly identify themselves in the Petition, but refer to Nuveen only as a "broker-dealer". Pet., p. 3. The record shows that Nuveen characterized itself as an underwriter of the sale of commercial paper in filings with state regulatory authorities. PX 6, App. II, 220, PX 7, Tr. 143.[2] The trial Court found, and the Court of Appeals has consistently affirmed, that Nuveen was the sole and exclusive underwriter of WH notes during the period involved. Judgment Order, A. 28; *Sanders II,* A. 63, 64, 69-70; *Sanders III,* A. 47; *Sanders IV,* A. 4.[3]

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[2] "Tr." refers to the transcript of the trial preceding *Sanders II.*

[3] Plaintiffs adopt defendants' designations of the four opinions of the United States Court of Appeals for the Seventh Circuit in this action. See Pet., p. 1. When citing those opinions plaintiffs shall refer to the Appendix filed by defendants.

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"Report on Atlantic Acceptance Urges Sweeping Rule Changes," 12/12/69, p. 89, col. 5 25

STATUTES INVOLVED

Section 2(10), 2(11), 5, and 12 of the Securities Act of 1933, 15 U.S.C. §§77b(10), 77b(11), 77e and 77l are the statutes involved in this case at this stage of the proceedings. Section 12 is set forth at pages A. 5-6 of the Statutory Appendix to the Petition for Certiorari. Sections 2(10), 2(11) and 5 are set forth in the Statutory Appendix annexed hereto.

In the Supreme Court of the United States

OCTOBER TERM, 1980

No. 80-299

JOHN NUVEEN & CO., INC., a corporation, INVESTORS SYNDICATE OF AMERICA, INC., a corporation, and INVESTORS DIVERSIFIED SERVICES, INC., a corporation,

Petitioners,

vs.

HENRY T. SANDERS, et al.,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR RESPONDENTS IN OPPOSITION

STATEMENT OF THE CASE

A. NATURE OF THE CASE

The trial Court found and the Court of Appeals affirmed that Nuveen was negligent in investigating the financial condition of WH and the suitability of WH notes sold by Nuveen to the investing public, and that Nuveen misrepresented material facts and omitted to state material facts in the sale of WH notes to the class in violation of §12(2)

of the Securities Act of 1933 ("Securities Act"). Judgment Order, ¶¶C-7, C-16, C-18,[1] A. 41, 43; *Sanders IV*, A. 2 *et seq.*

The trial Court further found that defendants violated §12(1) of the Securities Act by selling unregistered WH notes to the class in violation of §5 of the Securities Act. Judgment Order, ¶C-19, A. 43. The Court of Appeals did not reach this issue. *Sanders IV*, A. 3, n. 1.

B. COURSE OF THE PROCEEDINGS

In *Sanders I* it was held on a certified question that the WH notes were securities not exempt from the anti-fraud provisions of the 1933 or 1934 Securities Acts. A. 85-92. *See* discussion of this ruling in *Sanders II*, A. 67; *Welch Foods, Inc.* v. *Goldman, Sachs & Co.*, 398 F. Supp. 1393, 1397 (S.D.N.Y. 1974). *Sanders I* also held that Nuveen sold WH notes to the public for investment. A. 89-91. *See Sanders II*, A. 75-77.

After remand and trial, judgment was entered on findings that defendants had violated §10(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j(b) ("§10(b)"), and Rule 10b-5 thereunder. That judgment was affirmed in *Sanders II*.

In *Sanders II* the Court held that Nuveen did not make a reasonable investigation to determine whether WH was engaging in fraudulent practices, A. 69, 71-73, *see Sanders III*, A. 50, and that Nuveen made implied representations to the class that Nuveen had reasonable grounds to believe the WH notes would be paid at maturity. A. 76. The Court further held that defendants Investors Diversi-

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[1] The term "C" refers to the Conclusions of Law contained in the Judgment Order.

fied Services, Inc. and Investors Syndicate of America, Inc. were controlling persons of Nuveen. A. 73-75. That holding is not now disputed.

Shortly following *Sanders II* this Court ruled that a finding of *scienter* was required to establish liability under §10(b). *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976). This Court then granted defendants' pending petition for *certiorari*, vacated *Sanders II*, and remanded the case to the Court of Appeals for further consideration in light of *Hochfelder*. 425 U.S. 929 (1976), A. 62.

In *Sanders III* the Court of Appeals held that the record did not show that Nuveen had knowledge that the WH notes were fraudulently issued, and reversed the judgment entered by the trial Court under §10(b). *Sanders III*, A. 50. The Court of Appeals disposed of two other grounds plaintiffs had advanced to support liability (involving §17(a) of the Securities Act and Rule 27 of the National Association of Securities Dealers), and then concluded that on the record it could not resolve the question whether defendants had violated §12(2) of the Securities Act. A. 51 *et seq.*

The case was remanded to the trial Court for ". . . further proceedings as may be necessary for the district court to make additional findings of fact and reach conclusions of law to support such judgment as the district court may reach on the possible liability of Nuveen under §12(2) of the 1933 Act." A. 59-60.

The Court of Appeals made it clear that it had not foreclosed plaintiffs from seeking a judgment on remand under §12(1) of the Securities Act. A. 60-61. (The Securities and Exchange Commission, as *amicus curiae* in *Sanders III*, took the position that a violation of §12(1) by Nuveen was shown in the record.)

In the trial Court plaintiffs, pursuant to leave of Court, amended their complaint only to list §12(1) as one of the sections of the Securities Act violated by defendants. The complaint previously contained an allegation that Nuveen had sold unregistered securities to the plaintiff class.

The trial Court permitted further discovery and conducted a supplementary evidentiary hearing. After briefing, the trial Court entered judgment for plaintiffs under §§12(1) and 12(2). A. 20 *et seq.* Further orders were entered in which each plaintiff's claim was allowed in a specific amount, A. 18, and in which attorneys' fees and expenses were awarded. A. 15-17. The Court of Appeals affirmed the judgment under §12(2), *Sanders IV*, A. 2, and rejected defendants' arguments that certain class members were not entitled to relief. *Sanders IV*, A. 13-14.[2]

C. OPERATIVE FACTS

1. The WH Fraud

The fraud perpetrated by WH and other basic facts are described in *Sanders II*. A. 63-67. Briefly, WH and its auditors overstated WH's accounts receivable and did not record all WH's indebtedness on the WH audit reports. This practice was followed for a period of ten years. By 1970 the accounts receivable were overstated by $14,000,000

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[2] At the hearing after remand defendants additionally objected to four claims on the ground that privity between Nuveen and each of those claimants had not been shown. In *Sanders IV* the Court of Appeals noted the lack of argument before it on those objections. A. 14. Defendants petitioned for rehearing on their objections to the four claims. After response by plaintiffs in which record proof of privity between Nuveen and each claimant was identified, the Court of Appeals denied the Petition For Rehearing. A. 1.

on WH's financial statements, and those statements did not reflect $1,750,000 of debt. A. 25, FF 14(c), (d).[3] At the time Nuveen sold the WH notes here involved WH's liabilities exceeded its assets.

In the Fall of 1969 an anonymous telephone call to an officer of the First National Bank of Chicago, one of WH's lenders, triggered an investigation of WH. Agreed Statement of Uncontested Facts ("Stip."), ¶24, App. II, 108. An *ad hoc* committee of lenders caused WH to retain new auditors, Peat, Marwick, Mitchell & Co., who quickly uncovered the fraud. A. 23-25, FF 11, 13, 14. Finally, on February 10, 1970, an officer of the National Bank of Detroit telephoned Nuveen, advised it of the investigation, and suggested that Nuveen talk with a certain officer of the First National Bank of Chicago. The head of Nuveen's commercial paper department did so that day, and then suspended the sale of WH notes. A. 35-36, FF 60. Later in February 1970 the WH notes sold by Nuveen were dishonored. A. 25, FF 15.

2. Underwriting And Sale Of WH Notes By Nuveen

For nineteen months, including the period involved in this lawsuit, Nuveen was the exclusive underwriter and seller of WH notes. Nuveen purchased the notes at a discount and offered and sold them at a lower discounted rate, or higher price, in order to realize a profit. A. 28, FF 27.[4]

In September to December 1968, the first quarter Nuveen sold commercial paper, Nuveen sold or held in inventory

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[3] The term "FF" refers to the Findings of Fact contained in the Judgment Order.

[4] It was stipulated that in selling and delivering the promissory notes of WH Nuveen made use of the U. S. mails and other instrumentalities of interstate commerce, A. 28, FF 27.

WH notes in amounts outstanding ranging from $2,618,000 to $2,890,000 at any given time. A. 28, FF 28. From January 1, 1969 to February 1970 (when it ceased selling WH notes) Nuveen purchased approximately 250 WH notes totalling $9,171,500 face value and sold approximately 275 WH notes with face value of $9,305,500. Nuveen's Answer to Interrogatory #3, App. I, 48. Over half of those sales were to individuals or for the accounts of individuals. Other purchases were by banks and insurance companies. A. 29, FF 30. Many of the purchases by banks were for customer accounts. The notes were sold in denominations as low as $1,000.00. Nuveen Trading Securities Ledger, PX 74, App. III, 419, Tr. 143, 160.

3. Investigation Of WH By Nuveen

In September 1968 Nuveen acquired the business and assets of Ashwell & Company ("Ashwell"). Nuveen never had sold commercial paper previously. A. 21-22, FF 4. Nuveen acquired some 40 commercial paper accounts, including WH, from Ashwell. A. 27, FF 25; A. 29, FF 31.

Ashwell had made no independent examination or investigation of WH's financial condition or corporate affairs since at least 1959. A. 27, FF 25; Tr. 230-1. Nuveen did not make any examination or investigation of any of Ashwell's accounts at the time of the acquisition of Ashwell, or prior to the time Nuveen commenced to handle commercial paper. A. 27, FF 25.

All commercial paper sold by Nuveen, including the notes issued by WH, was rated "Desirable" by the National Credit Office ("NCO"), a subsidiary of Dun and Bradstreet, in a rating system in which "Prime" was the highest rating and "Desirable" was the second rating. A. 30, FF 37.

After acquiring Ashwell, Nuveen hired a credit investigator to investigate the credit of all commercial paper issuers handled by Nuveen. A. 31, FF 40.

Credit was checked by examining financial statements received from the issuer, and reports on issuers received regularly from NCO. A. 31, FF 41. Nuveen had no requirement that the issuers have financial statements certified by a certified public accountant. A. 29-30, FF 34. Its credit investigator never checked any of the financial statements for accuracy, but compiled some 30 ratios from those statements, which were entered on sheets called "spread sheets". A. 31-32, FF 42.

Nuveen's credit investigator also addressed credit inquiries to banks which were lenders to the issuers. One credit investigator, David Vermeer, testified that the replies from banks did not tell anything about the financial strength of the issuer being checked; and Dale Daniels, head of Nuveen's Commercial Paper Department, confirmed that, "You don't get a credit evaluation out of banks." A. 31, FF 41.

In March 1969 Vermeer made a one-day visit to WH to determine whether WH's receivables were good, were aged properly, and how much delinquency in payments existed. A. 32, FF 46. Vermeer did not examine any internal control or accounting records, such as ledgers, nor any corporate records of WH. A. 33, FF 47. Vermeer testified he "most likely did" examine WH's federal tax returns because it was his practice to do so. A. 33, FF 47.

WH's 1968 tax return did not agree with WH's financial statement for that year. Stip. ¶47, App. II, 117. The tax return showed a loss of $995,000 in 1968, Stip. ¶47, App. II, 117; while the 1968 financial statement WH had sent to Nuveen showed a profit of $499,119.09 before provision of $244,000 for income taxes for the year. JX 3, App. II,

152, Tr. 166-167. WH paid no income tax in 1968. In addition, the beginning 1968 balance sheet on the tax return did not agree with the ending 1967 balance sheet on the 1967 return. Stip. ¶47, App. II, 117.

Vermeer was discharged in July 1969 and Donald Reid, then head of Nuveen's Commercial Paper Department, assumed responsibility for checking the credit of commercial paper issuers; but Reid testified he was overburdened and did not have time to do credit investigations. A. 33, FF 48, 50. Reid left Nuveen at the end of October 1969; he testified that one reason he left was that defendant Investors Syndicate of America would not honor his request for additional personnel. A. 34, FF 52. Daniels replaced Reid in November 1969. A. 34, FF 52.

Kenneth Wahlberg, Senior Vice President of Investors Diversified Services and a member of a three-man executive committee empowered to conduct and supervise Nuveen's operations, A. 22, FF 6, gave instructions in October 1969 to hire a credit investigator for the Commercial Paper Department. A. 34, FF 53. In December 1969 Nuveen hired Richard Ferreira as a credit investigator. A. 34, FF 54. From that time until Nuveen terminated its commercial paper operations in June 1970, the Commercial Paper Department consisted of Daniels, Ferreira, two salesladies and some clerical help. A. 34, FF 54.

Ferreira made no on-site inspections while he was with Nuveen, but otherwise used the same system for checking credit that Vermeer had followed. A. 34, FF 55.

In late December 1969, while on a whirlwind tour to familiarize himself with the commercial paper accounts handled by Nuveen's Chicago office, Daniels had lunch

with Milton Hirsch, the President of WH. A. 34-35, FF 56. Daniels noted that Hirsch looked ill and ordered Ferreira to do a credit report on WH. A. 35, FF. 56. In that report Ferreira rated WH notes "Desirable", the same rating given by NCO, and further reported that the audit report of WH which he examined was a "detailed audit". A. 35, FF 59.

On January 22, 1970, *after* he had written his report on WH, and at the urging of Daniels, Ferreira sent credit inquiries on WH to a dozen banks. Ultimately, on February 10, 1970, Nuveen was advised by a bank officer of WH's fraud. A. 35-36, FF 60.

On Daniel's recommendation Nuveen stopped selling all commercial paper in June 1970. Daniels testified that the reason for the discontinuance was that he felt he was a commercial paper operator in a bond house, and he felt uncomfortable; that he had neither the support nor the technical operation necessary to run a commercial paper operation; and that he ". . . never felt that John Nuveen & Company was a company to do a job in commercial paper . . . ." A. 36, FF 61.

4. Nuveen's Dissemination Of Commercial Paper Reports And Confirmation Statements

Nuveen customarily prepared "Commercial Paper Reports" on issuers; and these reports were distributed to buyers or potential buyers. A. 30, FF 35.

The Nuveen reports on WH summarized the false information contained in the WH financial statements. In addition, Nuveen represented that the figures on WH were from a detailed audit, when WH's auditors had stated in those financial statements that a detailed audit had

not been made. Compare JX 1, JX 2, JX 3, App. II, 131, 135-136, 142, Tr. 166-167, with PX 102, App. III, 567, Tr. 665; PX 103-PX 107, App. IV, 618-630, 696. The reports contained additional information as to the history, business and operations of WH, and a description of WH executive personnel.

Every member of the plaintiff class received from Nuveen a confirmation statement of his purchase of a WH note here at issue. PX 68, Tr. 143, 157-159. Each confirmation statement shows the face amount of the note sold, the price paid by the purchaser, the due date of the note, and states that Nuveen has sold the note as a principal.

Sanders' testimony at the trial in 1974, Tr. 112 *et seq.*, and the testimony of five additional witnesses on behalf of eight class members at the 1978 evidentiary hearing following remand, App. IV, 705 *et seq.*, establish that Nuveen's personnel recommended WH notes to purchasers. Nuveen's Trading Securities Ledger, the confirmation statements and the fact that Nuveen sold notes through 17 regional offices, Stip. ¶7, App. II, 104, by its entire sales staff, Tr. 208, show that Nuveen sold WH notes in the same manner that common stocks are sold.

Nuveen sold WH notes on the basis that there would be no question that the notes would be paid when due. A. 30, FF 35, Tr. 339.

D. THE JUDGMENT ENTERED BELOW

The total of the unpaid principal balances due members of the plaintiff class under the WH notes each of them had purchased from Nuveen, together with pre-judgment interest, equaled $914,313.53; and the trial Court

entered judgment in that amount. App. IV, 685. Following expiration of the stay of mandate granted by the Court of Appeals, defendants deposited with the Clerk of the District Court the sum of $1,035,309.65 in satisfaction of the judgment. That sum includes post-judgment interest. The Clerk has invested that deposit in interest-bearing securities pending disposition of the instant Petition and further order of Court.

The attorneys for the plaintiff class were awarded fees of $394,990.50 for their first nine years of service in this case. A. 15-17.

REASONS FOR DENYING THE PETITION

I. THE RECORD REVEALS THAT NUVEEN SOLD WH NOTES IN VIOLATION OF SECTION 12(2) OF THE SECURITIES ACT.

Section 12(2) fastens liability upon any person who sells a security by means of a prospectus or oral communication in which material facts concerning that security are misrepresented or omitted in a misleading fashion, and who does not establish that he did not know, and in the exercise of reasonable care could not have known, of the misrepresentation or omission. Defendants do not contest the falsity of the WH Commercial Paper Reports Nuveen prepared, or the misleading nature of the oral statements Nuveen's salesmen made to the class members who testified to their conversations with those salesmen.

Defendants seek to avoid the plain thrust of §12(2) in three ways. First, defendants argue that Nuveen had no responsibility to investigate or examine WH at all, and is absolved of all liability because it relied on audit reports which defendants claim were properly certified. Second, defendants say Nuveen was not negligent in its investigation of WH. Finally, defendants argue that Nuveen made no statement whatsoever to the majority of the plaintiffs which caused the purchase by any of them of a WH note from Nuveen. Defendants' arguments do violence to the record and to the law.

A. The Court Below Correctly Measured Nuveen's Duties Against The Standard Of Reasonable Care Mandated By Section 12(2).

If a party disseminates false information in a prospectus or oral communication concerning a security, that party is absolved of liability under §12(2) only if it is able to show that ". . . in the exercise of reasonable care

[it] could not have known [,] of such untruth or omission, . . ." By its terms §12(2) applies whether or not the securities are exempt from registration. *Hill York Corp.* v. *American International Franchises, Inc.*, 448 F.2d 680, 695 (5th Cir. 1971). Thus, §12(2) demands that all offerors or sellers of securities take reasonable care that statements made concerning securities offered or sold by them are true and are not misleading.[5]

"Reasonable care" is conduct free from negligence, and §12(2) has been uniformly interpreted as establishing a standard of negligence for all offerors or sellers of securities. *Alton Box Board Co.* v. *Goldman, Sachs & Co.*, 560 F.2d 916, 922-924 (8th Cir. 1977); *Franklin Savings Bank* v. *Levy*, 551 F.2d 521, 526-527 (2d Cir. 1977). *See Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 209-210 (1976).

The task in determining whether liability exists under §12(2), where *scienter* is not present, is to determine whether the offeror or seller was negligent in offering or selling a security in a misleading fashion. As in any negligence case, whether negligence exists must be determined from all the circumstances of the situation. *Tiller* v. *Atlantic Coast Line R. Co.*, 318 U.S. 54, 67 (1943). The relationship between the injuring and injured party is a significant circumstance. *U. S.* v. *Folk*, 199 F.2d 889, 891 (4th Cir. 1952).[6] The Court below properly considered

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[5] *See Wilko* v. *Swan*, 346 U.S. 427, 430-31 (1953) (". . . the Act requires issuers, underwriters and dealers to make full and fair disclosure of the character of securities sold in interstate and foreign commerce and to prevent fraud in their sale. To effectuate this policy, §12(2) creates a special right to recover for misrepresentation. . ."); *Scherk* v. *Alberto-Culver Co.*, 417 U.S. 506, 512-514 (1974).

[6] The S.E.C. has recognized that the degree of care required of an underwriter under the Securities Act will vary with the circumstances of the offering. *See Charles E. Bailey & Co.*, 35 S.E.C. 33, 42-43 (1953).

the circumstances in which Nuveen sold WH notes to the class, giving due weight to Nuveen's status as an underwriter, A. 10-13, and concluded that ". . . the reasonable care standard required the reasonable investigation described in *Sanders II*." A. 13. Nuveen's role as exclusive underwriter of the sale of WH notes required that Nuveen make a reasonable investigation to determine that the notes were not fraudulently issued.[7]

Defendants point out that the term "reasonable investigation" appears in §11 of the Securities Act. Therefore, defendants argue, to find an underwriter negligent under §12(2) for failure to make a reasonable investigation distorts the pattern or scheme of the Securities Act.

Defendants' argument is simplistic. The reading consonant with Congressional intent is that a seller of securities must take reasonable care not to mislead those who invest in the securities whether or not they are registered. Whether the care actually taken is reasonable will depend upon the ability and position of the seller to learn the facts, among other considerations. As the Courts below pointed out, Nuveen had full access to WH's files, records, and offices. *Sanders IV*, A. 10-11; *Sanders II*, A. 69-70, 73. Nuveen was positioned to determine whether WH notes should be loosed upon the investing public and were suitable for sale under Nuveen's methods for selling commercial paper, i. e., that there would be no doubt that the paper would be paid when due. A. 30, FF 35. To sell in that manner

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[7] In purchasing and distributing WH notes Nuveen falls squarely within the definition of an underwriter in §2(11) of the Securities Act. Defendants' argument that the term "underwriter" has meaning only under §11 has no basis. That sellers of unregistered securities may be underwriters is recognized by sellers of commercial paper and the securities industry generally. See, e.g., BNA Sec. Reg. & Law Report, No. 569 (Sept. 10, 1980), pp. A-8-9.

required that Nuveen make a reasonable investigation to determine that the notes, indeed, would be paid when due.

The careful analysis by the Court of Appeals of the differences in the language of §§11 and 12(2), and the duties imposed upon all sellers of securities under §12(2) as contrasted with the duties of sellers of registered securities in §11, A. 11-13, is contested by defendants. Defendants claim the relevant House Report refers only to securities sold pursuant to a registration statement. Such a reading is highly selective and obscures Congressional intent as well as specific references in that Report to §12(2). Defendants quarrel that the duty of an underwriter cannot be greater under §12(2) than under §11. The short answer is that the Court below has not imposed a more rigorous standard of conduct or duty upon Nuveen in this case than is imposed upon an underwriter of registered securities by §11. The Court below applied a standard of care applicable to the particular facts and circumstances of this case, and determined that to take reasonable care under those facts and circumstances Nuveen had "'. . . to make at least some investigation directed at the question whether the ever present possibility of fraud is in fact a reality.'" A. 11, quoting *Sanders II*, A. 73.

Nor did the Court below simply apply §11 standards of investigation in determining that Nuveen had been negligent, as defendants would have this Court believe.[8]

The distortion of the statutory pattern of the Securities Act found by defendants in the decision below is a manufactured one, and ignores Congress' stated purposes, both

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[8] The Court below met defendants' contention directly. "Since what constitutes reasonable care under §12(2) depends upon the circumstances, we, of course, do not intimate that the duty of a seller under §12(2) is always the same as that of an underwriter in a registration offering under §11." A. 13.

in the legislative history and in the statute itself.[9] The Court below correctly applied §12(2) to the facts of this case in complete harmony with the legislative intent expressed in the statute.

B. The Investigation Of WH Made By Nuveen Was Negligent.

Nuveen did not investigate WH at all before it commenced to sell WH notes. Tr. 236-7, 415. When it did hire one credit investigator (and Nuveen never had more than one credit investigator for the 40-50 issuers of the short-term notes Nuveen sold), that investigator checked credit primarily by compiling ratios from WH's financial statements. A. 31, FF 42; Tr. 389-90; Tr. 579-80. The credit investigator for Nuveen who made a one-day visit to WH's office, Vermeer, testified that he was supposed to examine WH's federal tax returns, and he testified he "most likely did" examine them. Tr. 411. If Vermeer did look at WH's 1968 tax return his negligence is plain. The tax return showed a loss ($995,000), Stip. ¶47, App. II, 117; while the "audited" financial statement showed a gain ($499,119). PX 3, Tr. 143. A simpler indication of fraud, or irregularity requiring further investigation, is difficult to imagine. If Vermeer didn't look at WH's tax return his negligence is equally plain. As this Court concluded in *Sanders II*, "The indications of questionable practices by WH were easily accessible to a competent underwriter with a question of fraud in mind."

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[9] Defendants torture the damage provisions of §11 and §12(2) to make it appear that the decision below raises the damage prospects under §12(2) higher than the potential damages under §11. The potential class of plaintiffs, of course, is much larger under §11. The relief decreed below, in effect, is rescission. Plaintiffs were required to assign their notes and to deposit them with the Court, to be delivered to defendants upon the return of the consideration paid, less amounts received in partial payments of the notes. App. I, 94-95.

A. 73. Clearly, Nuveen made an investigation of WH which was negligent.

Defendants imply that their investigation of WH satisfied statutory requirements because Nuveen made inquiries of bank lenders, and the bank lenders did not tell Nuveen that anything was wrong with WH. Whatever the lending banks did, their legal obligations did not arise under the Securities Act. *See Sanders II,* A. 72. Nuveen cannot avoid its statutory responsibilities with the claim that it made inquiry of others who had no obligation under the Securities Act to investigate at all.

Defendants further argue that their actions in selling WH notes were reasonable because they relied upon certified financial statements of WH which WH submitted to them.[10]

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[10] While the S.E.C., in an *amicus* brief previously filed in this case, took the position that ". . . the long-form Lieber audit report itself raised no necessity for further inquiry" (a position with which plaintiffs do not agree), the S.E.C. also stated that: "Notwithstanding that there are no 'red flags' here, we agree with this Court that: "The underwriter is under a duty to make at least some investigation directed at the question whether the ever present possibility of fraud is in fact a reality' ". S.E.C. Brief, 74-2407 and 75-1260 ("S.E.C. Brief"), p. 68, quoting *Sanders II.*

The S.E.C. then went on to express concern over the statement of then Judge Stevens that ". . . a request to examine federal income tax returns, corporate minute books and accountants [sic] work papers . . . would have revealed the fraud. . . ." S.E.C. Brief, p. 68. This statement was misinterpreted by the S.E.C. (and by defendants) as requiring an underwriter to analyze the work product of the auditors. But, the Court in *Sanders II* pointed out that auditor's work papers did not exist or were not available, A. 66, and in the statement quoted obviously meant that Nuveen should have taken some steps to determine whether an audit actually had been performed.

The position of the S.E.C. before the Court of Appeals in

(footnote continued)

Again, defendants look to §11 and argue that under that section the underwriter of a fraudulent, registered securities issue is exonerated if the issuers' financial statement has been audited. Nothing in §11 states that once a certified audit is rendered an underwriter has no further duty of investigation, but may rely solely upon the audit as presented to it.[11]

"With regard to parts attributed to an expert other than himself, a defendant has the lesser burden of proving that 'he had no reasonable ground to believe and did not believe . . . that the statements therein were untrue or [contained a misleading or unlawful omission of a material fact] . . . .' " Note, "Escott v. BarChris: 'Reasonable Investigation' And Prospectus Liability Under Section 11 of the Securities Act of 1933," 82 Harv. L. Rev. 908, 909 (1961) ("Note"). While the duty to investigate expertised portions of a registration statement may be less

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(footnote continued)

Sanders III was that, "Under the Special Circumstances of this Case, the Imposition of Liability against Nuveen under Section 12(2) Would Not Be Inappropriate." S.E.C. Brief, heading, p. 60. In the section following that heading, the S.E.C. pointed out that this case involved commercial paper sold to ". . . unsophisticated individual investors purchasing non-prime quality, non-discountable commercial paper." S.E.C. Brief, pp. 69-70.

The S.E.C. then stated that it was the Congressional mandate that the duty of care vary, *inter alia*, ". . . with the degree of protection that the public has a right to expect, . . ." S.E.C. Brief, p. 72, citing H. R. Rep. No. 85, 73d Cong., 1st Sess. 9 (1933). The S.E.C. then terminated that section with the comment, "If, however, . . . [Nuveen's] duty were measured against an assumption that sophisticated, institutional, purchasers did not need the benefits of registration, we conclude that Nuveen would have 'just barely established that [it] reasonably investigated * * *.' " (Citation omitted.) S.E.C. Brief, p. 76.

[11] See Folk, "Civil Liabilities Under The Federal Securities Acts: The BarChris Case," 55 Va. L. Rev. 199, 211-215 (1969). (Hereinafter "Folk, p. ----".)

rigorous than the duty to investigate the non-expertised portions, the underwriter may not ignore discrepancies which he knows, or should know, exist (e.g., in this case, that the tax return and the financial statement could not be reconciled). Thus, in *Chris-Craft Industries, Inc.* v. *Piper Aircraft Corp.*, 480 F.2d 341 (2d Cir.), *cert. denied*, 414 U.S. 910 (1973), an underwriter was held liable under §14(e), 15 U.S.C. §78n(e), for misstatement in a registration statement of the book value of an asset when the corporate minutes showed discussions of the possible sale of the asset at a substantially lower figure. 480 F.2d at 367, 371-373.

Certainly it is incumbent upon the careful underwriter to determine whether in fact an audit had been made, whether selling registered or unregistered securities. (For discussions of §11 duties *see, Feit* v. *Leasco Data Processing Equipment Corp.*, 332 F. Supp. 544, 576-579, 581-583 (E.D.N.Y. 1971); *Escott* v. *BarChris Construction Corp.*, 283 F. Supp. 643, 692-697 (S.D.N.Y. 1968); Note, *supra*, 82 Harv. L. Rev. at 911-916.)

In this case Nuveen did not know and had never met anyone at Lieber, Bleiweis & Co., the auditing firm. Nuveen made no effort to find out whether an audit in fact had been made.

Refutation of defendants' argument is that the Congressional plan in the Securities Act was not to insulate underwriters, sellers, and offerors from liability whenever an issuer presents a certified audit of its affairs, but to require that underwriters and sellers of securities act prudently and carefully to avoid misleading the investing public when selling securities in interstate commerce.

C. Nuveen Misrepresented Material Facts In Selling WH Notes To Members Of The Plaintiff Class.

Defendants acknowledged below that Nuveen's commercial paper reports were used in the sale of WH notes.[12]

Nuveen's commercial paper reports on WH are prospectuses, since they admittedly were prepared for the purpose of selling WH notes.[13] Sales brochures are "prospectuses" under §12(2). *DeMarco* v. *Edens,* 390 F.2d 836, 840 (2d Cir. 1968).

Nuveen disseminated its commercial paper reports widely to prospective purchasers of commercial paper.[14] That those reports were false and misleading is not contested. While plaintiffs introduced evidence of receipt of a Nuveen report on WH by only nine plaintiffs, the admitted use of those reports in connection with the sale of WH notes taints the entire issue. The commercial paper reports were principal instruments utilized by Nuveen to market notes.

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[12] A. 30, FF 35. The interrogatory answer referred to in FF 35 reads:

> "7. Please list any and all written or printed material which was used by any of the Defendants in making or effectuating purchases or sales of any securities of Winter & Hirsch.
>
> "7. Purchase confirmations; sale confirmations; and John Nuveen & Co. Incorporated 'Commercial Paper Report' on Winter & Hirsch Inc., as revised from time to time. Said documents have heretofore been produced to counsel for the plaintiff pursuant to Rule 34." App. I, 50.

[13] The term "prospectus" is defined in §2(10).

[14] The WH Commercial Paper Reports were issued during the entire period Nuveen sold WH notes. Nuveen even issued a report on WH which was dated April 23, 1968, which is prior to the date it acquired Ashwell. PX 103, App. IV, 618-620, 696. No sale to a class member preceded distribution of a WH commercial paper report by Nuveen.

Again, defendants attempt to base their argument upon the statute. The searching analysis by the Court below of the legislative history of the Securities Act on this point, A. 8-10, withstands defendants' attack. Defendants, in effect, ask this Court to place a judicial gloss on the statute that would nullify Congressional intent.

Defendants argue that each member of the plaintiff class must prove that it received Nuveen's Commercial Paper Report on WH and that the class member bought his WH note because of the statements made in the report. As the Court below pointed out, "It is well settled that §12(2) imposes liability without regard to whether the buyer relied on the misrepresentation or omission." (Citations omitted.) A. 7. Congress, in §12(2), ". . . did not impose the burden of proving reliance on the false statement as a condition of recovery." *Gilbert* v. *Nixon,* 429 F.2d 348, 357 (10th Cir. 1970); *Woodward* v. *Wright,* 266 F.2d 108, 116 (10th Cir. 1959). To the same effect, *see Wigand* v. *Flo-Tek, Inc.,* 609 F.2d 1028, 1034 (2d Cir. 1979), citing *DeMarco* v. *Edens,* 390 F.2d 836 (2d Cir. 1968); Douglas and Bates, "The Federal Securities Act of 1933," 43 Yale L. J. 171, 174 (1933).

Defendants nevertheless argue that proof of causation is necessary under §12(2), and the fact that not every plaintiff proved he received Nuveen's Commercial Paper Report shows that causation is not present. In so arguing defendants seek to inject into §12(2) the reliance requirement of the common law action of deceit. "The deceit action is maintainable . . . only by one to whom, or to influence whom, the representation is made." Shulman, "Civil Liability and the Securities Act," 43 Yale L. J. 227, 239 (1933). The 'special right' to recover provided under §12(2) ". . . was intended to substantially change the common law concept of liability for fraud and deceit . . ." *Woodward* v. *Wright,* 266 F.2d 108, 116 (10th Cir. 1959).

At common law it is necessary to show that the buyer or seller relied on the misrepresentation, and that without the misrepresentation the transaction would not have occurred.[15]

Reliance need not be proved to establish liability under §12(2). "Causation" under §12(2) is thus not a common law concept. That requirement is satisfied by proof that the defendant was the instrumental factor in effecting the transaction. *Croy* v. *Campbell,* CCH Fed. Sec. L. Rep., Current Binder, ¶97,615 (5th Cir. 1980).

The necessary causal nexus may be found in the sale of the notes by Nuveen and Nuveen's negligent failure to investigate to determine that the prospectus issued by Nuveen was not misleading. *See Alton Box Board Co.* v. *Goldman, Sachs & Co.,* 560 F.2d 916, 924 (8th Cir. 1977).

It is a tenable view that the showing of causation under §12(2) limits recovery by the purchaser to his immediate seller.[16] In this case, where Nuveen sold each WH note to

---

[15] "The causal connection between the wrongful conduct and the resulting damage, essential throughout the law of torts, takes in cases of misrepresentation the form of inducement of the plaintiff to act, or to refrain from acting, to his detriment. . .

"In order to be influenced by the representation, the plaintiff must of course have relied upon it, and believed it to be true." Prosser, *Handbook of the Law of Torts* (4th ed. 1971), §108, at p. 714.

[16] Professor Folk contends that the concept of causation has no utility in determining liability under §12(2) where privity is required. "Privity is strict and causation is irrelevant. . ." Folk, p. 203.

each member of the plaintiff class, that view of §12(2) presents no obstacle to recovery for the class.[17]

Jackson v. *Oppenheim*, 533 F.2d 829 (2d Cir. 1976) is distinguishable, as the Court below distinguished it, since a conversation upon which plaintiff there sought to base liability was unrelated to the sale of the security. A. 9, note 7.[18]

The WH notes were not and could not be sold in a transactional vacuum. They were sold in a market created by Nuveen, by means of Nuveen's commercial paper reports, and other sales efforts. Nuveen alone offered and sold those notes to the public, including every member of the plaintiff class. In that situation the causation requirement for liability under §12(2) is satisfied as to each member of the plaintiff class. See H. R. Rep. No. 85, 73d Cong., 1st Sess. 10 (1933).[19] The reading of the statute by the Court below is correct. A. 8-10.

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[17] Even under the more onerous burden of proof prescribed under §10(b) of the Securities Exchange Act of 1934 proof of causation is supplied by proof that the misstatements are material. *TSC Industries* v. *Northway, Inc.*, 426 U.S. 438 (1976). It is not controverted that Nuveen's reports on WH were materially misleading.

[18] Neither *Mason* v. *Marshall*, 412 F. Supp. 294 (N.D. Tex. 1974), nor *Lorber* v. *Beebe*, 407 F. Supp. 279 (S.D.N.Y. 1976), supports defendants' causation argument. Pet., p. 24. In *Mason* the Court found no §12(2) liability because the allegedly misleading statement was not material, 412 F. Supp., at p. 301; while in *Lorber* the stock plaintiff purchased was not part of the stock issue with which the allegedly misleading prospectus was concerned. 407 F. Supp, at p. 286.

[19] For a first-hand account of the evolution of the Securities Act in the House and Senate Committees, see Landis, "The Legislative History of The Securities Act of 1933," 28 Geo. Wash. L. Rev. 29 (1959).

II. THE JUDGMENT UNDER SECTION 12(2) MAY BE SUSTAINED ON OTHER GROUNDS.

The decision below may be upheld on the ground that a confirmation statement is a "prospectus" as defined by the Securities Act, §2(10). The record shows that each member of the class received a confirmation statement, PX 68, and that the confirmations contained misleading statements, and omitted material facts.[20]

The decision below also may be upheld on the ground that Nuveen represented to each member of the plaintiff class, by implication, that Nuveen had taken reasonable care to determine that the WH notes it sold were suitable for investment, and that these notes would be paid when due. There is ample authority for this view. *Alton Box Board Co.* v. *Goldman, Sachs & Co.*, 560 F.2d 916, 922-3 (8th Cir. 1977); *Franklin Savings Bank* v. *Levy*, 551 F.2d 521, 526-7 (2d Cir. 1977); *University Hill Foundation* v. *Goldman, Sachs & Co.*, 422 F. Supp. 879, 893 (S.D.N.Y. 1976).

Plaintiffs will not present either argument at this juncture.

III. THE DECISIONS BELOW HAVE NOT HAD AND WILL NOT HAVE A DAMPENING EFFECT ON THE COMMERCIAL PAPER MARKET.

Defendants point out the enormous size of the market for commercial paper that exists today, Pet., p. 16, n. 19, and argue, *in terrorem*, that the decision below will impair that vital market.

We agree that the market for commercial paper has burgeoned and now is enormous. That growth has taken

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[20] It was the view of the S.E.C. before the *Sanders III* Court that since each member of the plaintiff class received a confirmation statement of his purchase from Nuveen, ". . . these sales were made by means of a written prospectus which contained a material omission." S.E.C. Brief, p. 59, continued footnote 117.

place since the Securities Act was enacted, and, in part, since the decisions in *Alton Box Board Co.* v. *Goldman, Sachs & Co.*, 560 F.2d 916 (8th Cir. 1977); *Franklin Savings Bank* v. *Levy*, 551 F.2d 521 (2d Cir. 1977); and *University Hill Foundation* v. *Goldman, Sachs & Co.*, 422 F. Supp. 879 (S.D.N.Y. 1976), all of which found sellers of dishonored notes liable for breaches of implied representations.

Nor did the consent decree entered following the Penn Central financial fiasco and subsequent dishonor of Penn Central's notes in *S.E.C.* v. *Goldman, Sachs & Co.*, CCH Fed. Sec. L. Rep., 1973-74 Transfer Binder, ¶94,556 (S.D.N.Y. 1974) (wherein Goldman, Sachs agreed to conduct a more rigorous investigation of issuers of notes than that found necessary by the Court below) stunt the growth of the commercial paper market.

The principal purpose of the Securities Act is to provide protection to the investing public. The gigantic size of the commercial paper market does not lessen the need for or desirability of affording that protection in accordance with Congressional intent.[21]

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[21] Among the companies that have dishonored their commercial paper are the following. Atlantic Acceptance Corporation, Ltd., see "Report of Atlantic Acceptance Urges Sweeping Rule Changes," N. Y. Times, 12/12/69, p. 89, col. 5; Pioneer Finance Co. ($3 million of commercial paper), see "Pioneer Finance: 'Tight Money' Claims A Casualty," N. Y. Times 9/26/66, p. 63, col. 3; Mill Factors Corporation ($6.7 million of commercial paper) see "Heavy, Heavy . . .", Forbes, 8/15/71, p. 21, "Financial Collapse and Human Tragedy Stalk Mill Factors," N. Y. Times, 4/23/69, p. 71, col. 1; Penn Central Transportation Company ($85 million of commercial paper), see "The Financial Collapse of the Penn Central Company," Staff Report of the SEC to the Special Subcommittee on In-

(footnote continued)

IV. NUVEEN SOLD UNREGISTERED SECURITIES TO THE PLAINTIFF CLASS IN VIOLATION OF SECTION 12(1).

It is plaintiffs' position that the record below shows a violation of §12(1) of the Securities Act. In *Sanders III* the S.E.C., as *amicus curiae*, urged the Court of Appeals to affirm on that ground. The trial Court found §12(1) had been violated; but the Court of Appeals did not reach the question. Even in the absence of any §12(2) violation the trial Court's judgment should be affirmed under §12(1).

CONCLUSION

For the foregoing reasons plaintiffs pray that the Petition for Certiorari be denied.

Respectfully submitted,

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(footnote continued)

vestigations (August, 1972); Beverly Hills Bancorporation ($13 million of commercial paper), see "Bancorp on Coast Reveals Problems," N. Y. Times, 12/31/73, p. 27, col. 7; Franklin N. Y. Corporation, see N. Y. Times, 1/13/75, p. 44, col. 7. Many of these defalcations are discussed in Note, The Commercial Paper Market and the Securities Act, 39 U. Chi. L. Rev. 362, 378 (1972).

APPENDIX

STATUTORY APPENDIX

Sections 2(10) and 2(11) of the Securities Act of 1933, 15 U.S.C. §77b(10), (11):

When used in this title [15 USCS §§77a et seq.] unless the context otherwise requires—

(10) The term "prospectus" means any prospectus, notice, circular, advertisement, letter, or communication, written or by radio or television, which offers any security for sale or confirms the sale of any security; except that (a) a communication sent or given after the effective date of the registration statement (other than a prospectus permitted under subsection (b) of section 10 [15 USCS §77j(b)]) shall not be deemed a prospectus if it is proved that prior to or at the same time with such communication a written prospectus meeting the requirements of subsection (a) of section 10 [15 USCS §77j(a)] at the time of such communication was sent or given to the person to whom the communication was made, and (b) a notice, circular, advertisement, letter, or communication in respect of a security shall not be deemed to be a prospectus if it states from whom a written prospectus meeting the requirements of section 10 [15 USCS §77j] may be obtained and, in addition, does no more than identify the security, state the price thereof, state by whom orders will be executed, and contain such other information as the Commission, by rules or regulations deem necessary or appropriate in the public interest and for the protection of investors, and subject to such terms and conditions as may be prescribed therein, may permit.

(11) The term "underwriter" means any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, or par-

ticipates or has a participation in the direct or indirect underwriting of any such undertaking; but such term shall not include a person whose interest is limited to a commission from an underwriter or dealer not in excess of the usual and customary distributors' or sellers' commission. As used in this paragraph the term "issuer" shall include, in addition to an issuer, any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer.

Section 5 of the Securities Act of 1933, 15 U.S.C. §77e:

(a) Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly—

(1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security through the use or medium of any prospectus or otherwise; or

(2) to carry or cause to be carried through the mails or in interstate commerce, by any means or instruments of transportation, any such security for the purpose of sale or for delivery after sale.

(b) It shall be unlawful for any person, directly or indirectly—

(1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to carry or transmit any prospectus relating to any security with respect to which a registration statement has been filed under this title [15 USCS §§77a et seq.], unless such prospectus meets the requirements of section 10 [15 USCS §77j]; or

(2) to carry or cause to be carried through the mails or in interstate commerce any such security for the purpose of sale or for delivery after sale, unless accompanied or preceded by a prospectus that meets the requirements of subsection (a) of section 10 [15 USCS §77j(a)].

(c) It shall be unlawful for any person, directly or indirectly, to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to offer to sell or offer to buy through the use or medium of any prospectus or otherwise any security, unless a registration statement has been filed as to such security, or while the registration statement is the subject of a refusal order or stop order or (prior to the effective date of the registration statement) any public proceeding or examination under section 8 [15 USCS §77h].

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No. 80-299

IN THE

Supreme Court of the United States

OCTOBER TERM, 1980

JOHN NUVEEN & CO., INC., a corporation, INVESTORS SYNDICATE OF AMERICA, INC., a corporation, and INVESTORS DIVERSIFIED SERVICES, INC., a corporation

Petitioners,

v.

HENRY T. SANDERS, et al.,

Respondents.

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

REPLY BRIEF OF PETITIONERS IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

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The respondents have filed a brief in opposition to the petition and, at the invitation of the Court, the Solicitor General has filed a brief for the United States as amicus curiae ("S.G.Br.").* Only a few points in these briefs merit response at this time.

* Other abbreviations used herein are the same as those used in the Petition. In compliance with Supreme Court Rule 28.1, as amended, petitioners hereby advise the Court that The St. Paul Companies, Inc. is the parent corporation of petitioner Nuveen and

(footnote continued)

I.

THE BRIEF OF THE SOLICITOR GENERAL IGNORES THE PRIOR BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION IN THIS CASE IN WHICH THE COMMISSION URGED CLARIFICATION OF THE RELATIONSHIP BETWEEN SECTIONS 11 AND 12(2) AND CONCLUDED THAT NUVEEN HAD ACTED WITH "REASONABLE CARE" ASSUMING THAT THE COMMERCIAL PAPER WAS NOT REQUIRED TO BE REGISTERED

The Solicitor General's position that "this case is not an appropriate vehicle for clarifying the relationship between Sections 11 and 12(2)" of the 1933 Act (S.G.Br. 7) is impossible to reconcile with the previous views of the SEC. On its own initiative the SEC filed a brief as amicus curiae in *Sanders III* (hereinafter referred to as its "prior brief") seeking, among other things, clarification of the relationship between those statutory provisions. The SEC thought the issues were significant then; they are no less significant now.

The Solicitor General's brief conspicuously omits discussion of positions taken by the SEC in its prior brief, positions which in significant respects are at odds with those now advanced by the Solicitor General. In its prior brief the SEC contended that in an action under Section 12(2) of the 1933 Act involving commercial paper which was not required to be registered, it was inappropriate to impose upon the seller the burdens imposed by Section

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that associated funds of petitioner IDS are Investors Mutual Inc., Investors Selective Fund, Inc., Investors Stock Fund, Inc., Investors Variable Payment Fund, Inc., IDS New Dimensions Fund, Inc., IDS Progressive Fund, Inc., IDS Growth Fund, Inc., IDS Bond Fund, Inc., IDS Cash Management Fund Inc. and IDS Tax-Exempt Bond Fund Inc.

11(b)(3) of the 1933 Act.* (SEC Br. 60-61, 69, 74) Notwithstanding the facts stated in the Solicitor General's brief (S.G.Br. 4), it was the SEC's view that if the commercial paper was not required to be registered, Nuveen met its obligation of reasonable care. (SEC Br. 61, 76) In *Sanders III*, after the SEC's amicus presentation, the Court of Appeals expressed "great doubt" that registration was required here. (A. 52) Therefore, the holding in *Sanders IV* that in these circumstances the exercise of "reasonable care" required discharge of the due diligence burdens imposed by Section 11 (A. 13) is inconsistent with the views expressed by the SEC.

Notwithstanding the statement of the Solicitor General to the contrary (S.G.Br. 8), the Court of Appeals explicitly held that in this case "the reasonable care standard [under Section 12(2)] required the reasonable investigation described in *Sanders II* [*i.e.*, in accordance with Section 11]." (*Sanders IV*, A. 13 footnote omitted) Thus, an important issue clearly presented by the Petition is whether such a convergence of the standards is ever appropriate and, if so, when. (*See* Question No. 1)

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* The Solicitor General and respondents repeatedly describe Nuveen as an underwriter. Petitioners have demonstrated, however, that Nuveen's status as an "underwriter", as that term is defined in Section 2(11) of the 1933 Act, does not determine the parameters of its liabilities. (Pet. 9-11) *See also Pharo* v. *Smith*, 621 F.2d 656, 671 (5th Cir. 1980), *reh. granted on other grounds*, 625 F.2d 1226 (5th Cir. 1980):

> Plaintiff also seeks to impose liability on Deltec as an underwriter, citing section 2(11) [of the 1933 Act]. Section 2(11) defines an underwriter, but it does not define unlawful conduct or create any liability for a person who is an underwriter. Accordingly, plaintiffs must predicate Deltec's liability on another provision of the [1933 Act].

In its prior brief the SEC took issue with the statement by the Court of Appeals in *Sanders II* that in certain circumstances a seller should review accountants' work papers. (*Sanders II*, A. 69; SEC Br. 68) Now the Solicitor General merely, and incorrectly, characterizes this troublesome ruling as, at most, an alternative holding. (S.G.Br. 8). The Solicitor General ignores the fact that the court below held that Nuveen had failed to exercise reasonable care because it had not "determin[ed] the basic integrity of the issuer's financial statements." (*Sanders II*, A. 72, followed in *Sanders IV*, A. 10-13) This language unmistakably imposed a burden upon the seller to take affirmative steps to verify the accuracy of certified financial statements, a burden which is manifestly not imposed by Section 11. (Pet. 12-14) The Petition thus squarely presents the further important question whether it is ever appropriate to impose greater burdens in an action under Section 12(2) than would be imposed under Section 11. (*See* Question No. 2)

Accordingly, the SEC was correct in contending in its prior brief that this case presents important issues. The Solicitor General has failed to address the fact that in large measure the SEC previously supported the petitioners and that the ruling below is inconsistent with the views expressed by the SEC.

Finally, the Solicitor General has *not* indicated agreement with the ruling below. The brief states merely that in the circumstances here presented "a standard of care that is the same or similar to that imposed by Section 11 *may* be appropriate" and "the standard of 'reasonable care' under Section 12(2) *may* converge with the standard of 'reasonable investigation' prescribed under Section 11". (S.G.Br. 7-8) (emphasis added) Where the questions presented are important and the ruling below may be in error, review should be granted by this Court.

II.

THE SOLICITOR GENERAL ACKNOWLEDGES THAT QUESTION NO. 3 IN THE PETITION IS SUBSTANTIAL

The Solicitor General acknowledges that the causation issue presented by Question No. 3 of the Petition (Question No. 2 as framed by the Solicitor General) is "not insubstantial". (S.G.Br. 9) The Solicitor General does *not* express agreement with the ruling below on this issue, which is not only "not insubstantial" as a legal matter but is important in the administration of the law. The Solicitor General merely suggests an absence of conflicting decisions. (S.G.Br. 10) (*But see Lorber* v. *Beebe*, 407 F.Supp. 279 (S.D.N.Y. 1976) (Pet. 24)) However, in recent years this Court has granted certiorari to decide important questions arising under the federal securities laws even though the case was one of first impression at the appellate level. *See Chiarella* v. *United States*, 100 S.Ct. 1108 (1980); *Touche Ross & Co.* v. *Redington*, 442 U.S. 560, 577 n. 19 (1979); *Securities and Exchange Commission* v. *Sloan*, 436 U.S. 103 (1978).

III.

THE PETITION PRESENTS SUBSTANTIAL QUESTIONS OF LAW AND DOES NOT SEEK REVIEW OF FINDINGS OF FACT

The Solicitor General seeks to portray this case as one that would require resolution of issues of fact by this Court, referring, for example, to "conflicting evidence." (S.G.Br. 3) On the contrary, one of the reasons that this case is particularly suited for review by this Court is that there was remarkably little conflicting evidence. The principal issues presented to the courts below related to the proper interpretation of provisions of the 1933 Act and

the application of those provisions to the largely undisputed facts.*

* There are, however, several misconceptions of fact in the brief of the Solicitor General. While it is true that Winter & Hirsch commercial paper was never rated "prime" by the National Credit Office (S.G.Br. 7), the difference between the "prime" and "desirable" ratings of that service was *solely* one of the size of the issuer, not its creditworthiness in a qualitative sense. *Mallinckrodt Chemical Works* v. *Goldman, Sachs & Co.*, 420 F.Supp. 231, 233 n. 3 (S.D.N.Y. 1976).

The statement that Nuveen "sold the notes on the basis 'that there should be no question but what the paper will be paid at maturity' " (S.G.Br. 1) was neither a guarantee by Nuveen nor a statement made to any plaintiff. It was a statement made by the head of Nuveen's commercial paper department *to the president of Winter & Hirsch* by way of explanation that Nuveen strove for that goal in choosing issuers of commercial paper and, therefore, was *terminating* its selling of Winter & Hirsch commercial paper upon learning of the rumors about its financial condition. (Trial Transcript 339)

The statement in Nuveen's commercial paper reports that the financial information contained therein was obtained from a "detailed audit" did not misrepresent any facts. (S.G.Br. 4, 6) A long form audit report with extensive schedules, such as the Lieber, Bleiweis reports on Winter & Hirsch, is called a "detailed audit report," even though it is not the result of a detailed audit of all transactions of the company. (Trial Transcript 275)

CONCLUSION

The Solicitor General's brief concludes with a lengthy footnote suggesting that, irrespective of the correctness *vel non* of the ruling below, this case should be ended and plaintiffs should be allowed to collect the judgment. (S.G.Br. 10 n. 11) This suggestion is extraordinary, particularly in light of the fact that the Solicitor General has neither expressed concurrence with the rulings below nor taken a position on the issues not resolved below. Moreover, on August 14, 1980, petitioners paid the full amount of the judgment to the Clerk of the District Court. Petitioners therefore have nothing to gain merely by protracting these proceedings, as intimated by the Solicitor General. Rather, petitioners seek an application of the federal securities laws consistent with the language of the statute and with recent decisions of this Court.

The SEC—the federal agency charged with the administration of the federal securities laws—has previously urged that the questions presented regarding the standard of care (Questions Nos. 1 and 2) do require clarification. The Solicitor General acknowledges that Question No. 3 is substantial. The Solicitor General does not contend that the case was correctly decided. For the reasons given herein and in the Petition for Certiorari, petitioners pray that the writ be granted.

Respectfully submitted,

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No. 80-299

In the Supreme Court of the United States

OCTOBER TERM, 1980

JOHN NUVEEN & CO., INC., ET AL.,
PETITIONERS

v.

HENRY T. SANDERS, ET AL.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE UNITED STATES AS AMICUS CURIAE

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QUESTIONS PRESENTED

1. Whether petitioner Nuveen, a securities underwriter, sustained its burden of proof under Section 12(2) of the Securities Act of 1933, 15 U.S.C. 77*l*(2), that "in the exercise of reasonable care [it] could not have known" of material misstatements and omissions in communications it made in connection with its sale of securities.

2. Whether petitioner Nuveen, which sold securities "by means of" misleading prospectuses, was properly held liable under Section 12(2) of the Securities Act to members of the plaintiff class who did not prove that they received copies of the prospectuses.

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This brief is filed in response to the Court's invitation to the Solicitor General to express the views of the United States.

STATEMENT

1. Beginning in September 1968, petitioner John Nuveen & Co., Inc. ("Nuveen"),[1] a broker-dealer, began to underwrite securities in the form of short-term notes issued by Winter & Hirsch, Inc. ("WH"), a consumer finance company (Pet. App. 28, para. 27). From that date until February 1970, Nuveen underwrote and sold virtually all of the short-term notes issued by WH (*ibid.*). In February 1970, WH collapsed after the discovery that certain of its principals, together with its accounting firm, had engaged in a massive fraud and had concealed the fact that the company was insolvent (Pet. App. 3-5; 24-25, paras. 13-14; 66).

Respondents are a class of 42 individuals and firms that, between June 30, 1969, and February 10, 1970, purchased WH notes with a face value of $1,612,500 from Nuveen (Pet. App. 3; 25, para. 16). The WH notes, rated as less than "prime" quality (Pet. App. 30, para. 37), were sold to the public by some of Nuveen's 172 registered representatives (Pet. App. 27, para. 26; 29, paras. 32, 33). Nuveen, unaware of the fraud, sold the notes on the basis "that there should be no question but what the paper will be paid at maturity" (Pet. App. 4; 30, para. 35). Over half of the WH notes were sold to, or for the account of, individuals (Pet. App. 29, para. 30). They were sold in denominations as low as $1,000 (III App. 419, 443).[2] Prior to their purchases of WH notes, some of the investors received from Nuveen materially misleading reports about the WH notes and at least some of them received from Nuveen materially misleading oral

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[1]The other petitioners in this case are two corporations held liable for Nuveen's actions due to their status as controlling persons.

[2]"App." refers to the four-volume appendix in the court of appeals.

communications about WH (Pet. App. 4; 6 & n.3; 38-40, paras. 70-76). After their purchases, all of the investors received confirmation statements from Nuveen stating that Nuveen had sold them the WH notes (Pet. App. 4). At the time of the sales, Nuveen had not learned and accordingly did not disclose in its reports, oral communications or confirmation statements the material fact that WH was in financial distress (Pet. App. 5).

In November 1969, rumors began to circulate among WH's lenders that WH's financial statements "were not right" (Pet. App. 23, para. 11). As a result, in January 1970 the lenders forced WH to retain a new accounting firm to conduct a full audit (Pet. App. 23-24, para. 11). Shortly after the audit was commenced the fraud was discovered. Upon learning of the fraud in February 1970, Nuveen stopped selling WH notes (Pet. App. 36, para. 60). The notes held by the respondent investors were dishonored by WH (Pet. App. 5). Through a liquidation distribution, respondents received approximately two-thirds of the amounts they paid Nuveen for the notes (*ibid.*).

2. In March 1970, respondents filed a class action complaint against Nuveen in the United States District Court for the Northern District of Illinois, alleging violations of various provisions of the federal securities laws in connection with Nuveen's underwriting and sale of WH notes. Respondents sought to recover the unpaid balance of the purchase price of the notes. Following a trial in the district court and three appellate decisions,[3] the district court held

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[3]In *Sanders I*, 463 F. 2d 1075, cert. denied, 409 U.S. 1009 (1972), the court of appeals held that the WH notes were securities. In *Sanders II*, 524 F. 2d 1064 (1975), vacated and remanded, 425 U.S. 929 (1976), the court affirmed a judgment in respondents' favor based on Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b). In *Sanders III*, 554 F. 2d 790 (1977), on remand for reconsideration in light of *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976), the court reversed the Section 10(b) judgment because scienter had not been proven. The court of

that Nuveen was liable under Section 12(2) of the Securities Act, 15 U.S.C. 77*l*(2), because it had sold securities by means of false and misleading prospectuses[4] and oral communications (Pet. App. 40, para. C-2; 42-43, paras. C-14 to C-16) and had failed to make an investigation sufficient to give it "reasonable grounds for believing that the financial condition of WH was such that WH would have the ability to pay its notes as they matured" (Pet. App. 41, para. C-5; see also *id.* at para. C-7).

In evaluating the issue of reasonable care, the district court was required to assess conflicting evidence. Nuveen asserted that it relied on certified financial statements showing a substantial profit, which supposedly had been audited by WH's accountants. Nuveen had "mistaken[ly] but honest[ly]" believed that those statements truthfully represented WH's financial condition (Pet. App. 5; 36, para. 63; 65). In addition, Nuveen had ascertained that various banks had extended credit to WH (Pet. App. 31, para. 41; 35, para. 60; 65). Furthermore, one of Nuveen's credit analysts spent a day at the offices of WH and examined certain records relating to its business transactions (Pet. App. 32, para. 46; 65).

In maintaining that Nuveen's actions had not been reasonable, respondents argued that Nuveen's personnel did not know and never attempted to meet anyone at the accounting firm that purportedly audited WH's financial statements. Furthermore, Nuveen never made any inquiries

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appeals remanded the case to the district court for further proceedings to consider respondents' claims under the Securities Act of 1933, 15 U.S.C. 77a *et seq.* The Securities and Exchange Commission participated in the court of appeals as amicus curiae in *Sanders III.*

[4]The term "prospectus" is defined in Section 2(10) of the Securities Act of 1933, 15 U.S.C. 77b(10), to include any written communication "which offers any security for sale or confirms the sale of any security."

of the auditor (Pet. App. 32, para. 44). Although the auditor's opinions noted that the certified financial statements had been prepared "without detailed audit" (Pet. App. 6; 37, para. 66), Nuveen prepared and distributed reports, incorporating portions of the certified financial statements, which erroneously stated that the financial data were in fact based on a detailed audit (Pet. App. 6). In addition, although Nuveen's credit analyst testified that he probably did examine WH's tax returns (Pet. App. 33, para. 47), WH's tax returns showed a loss of approximately one million dollars, while its financial statements reflected substantial profits (II App. 117, 152). Finally, the evidence showed that Nuveen did not examine WH's corporate minutes or its records of corporate actions (Pet. App. 31, para. 39).

In addition to holding that Nuveen was liable under Section 12(2) because it failed to exercise reasonable care necessary to avoid misleading investors, the district court also found that Nuveen was liable under Section 12(1) of the Act, 15 U.S.C. 77*l*(1), because it had sold WH's notes when no registration statement was in effect (Pet. App. 43, paras. C-18 & C-19).

3. The court of appeals affirmed the district court's decision, concluding that Nuveen was liable under Section 12(2) of the Securities Act (Pet. App. 2-14). The court found it unnecessary to decide whether Nuveen also was liable under Section 12(1) (Pet. App. 3 n.1). In finding liability under Section 12(2), the court of appeals focused on the misleading reports distributed by Nuveen to some members of the plaintiff class prior to their purchases. Since misleading reports had in fact been distributed to members of the plaintiff class, the court reserved decision on the question whether Nuveen also was liable on grounds that it had made misleading oral statements in connection with the sales, had failed to disclose material facts when it forwarded confirmation statements, or had implicitly represented that the

securities were issued by a solvent company when it underwrote and distributed them to the public (Pet. App. 6 n.3).

The court of appeals affirmed the district court's factual finding that Nuveen failed to exercise reasonable care to avoid misleading investors, noting that "what constitutes reasonable care under Section 12(2) depends upon the circumstances" (Pet. App. 13). After summarizing the evidence, the court pointed out that Nuveen was the "exclusive underwriter" of the WH notes (Pet. App. 4; see also *id.* at 69-72), that a "greater quantity of information" was available to Nuveen as an underwriter than would be available to a mere broker (*id.* at 10), and that the WH notes were sold to public investors without registration (*id.* at 13 n.13). The court also incorporated by reference (*id.* at 13) the analysis contained in one of its prior decisions in this case, which had noted that the "short term" nature of the WH notes "enhanced the importance of determining the basic integrity of the issuer's financial statements" and of confirming WH's ability "to pay its bills in the immediate future" (*id.* at 72).

The court of appeals rejected Nuveen's assertion that it could not be held liable under Section 12(2) because the evidence did not show that each investor in the plaintiff class received a misleading prospectus. The court concluded that causation of injury was established because Nuveen sold securities to some purchasers through misleading prospectuses and "publication of WH's true financial condition would have caused a total collapse of the market for its notes" (Pet. App. 9).

DISCUSSION

The decision of the court of appeals does not conflict with any decision of this Court or any other court of appeals. Moreover, the decision appears to turn in substantial part

on the facts of this particular case, and its precedential value in other circumstances is a matter of speculation. Accordingly, review by this Court is unwarranted.

1. Section 12(2) of the Securities Act, 15 U.S.C. 77*l*(2)—a civil liability provision applicable to material misrepresentations and omissions in the sale of registered or unregistered securities—provides an affirmative defense to a defendant who is able to prove that "in the exercise of reasonable care [it] could not have known" of the misrepresentations or omissions. Petitioner Nuveen argues (Pet. 17) that the district court and court of appeals erroneously found that it failed to meet its burden of proof on the issue of reasonable care. There is no need, however, for this Court to review the concurrent factual findings of the lower courts concerning petitioner's negligence.[5]

The inappropriateness of granting review of the facts of this particular case is highlighted by the unusual nature of those facts. The record in this case showed that Nuveen stated to investors that its reports rested on a detailed audit, even though the financial statements that it relied on contained a contrary representation (Pet. App. 6). The need for care arguably was increased in this case by the fact that the notes that Nuveen sold had characteristics unusual for commercial paper. The notes were sold in small denominations, and over half of them were purchased for the account of individuals or by individuals directly, rather than by sophisticated institutional investors (III App. 49; Pet. App.

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[5]Determining whether a defendant has fulfilled a standard of due care requires an assessment of all the facts of record, a task for the lower courts to perform. See, *e.g.*, *Schulz* v. *Pennsylvania R.R.*, 350 U.S. 523, 525 (1956). Congress recognized that liability under Section 12(2) would depend upon the defendant's "importance * * * in the scheme of distribution and * * * the degree of protection that the public has a right to expect." H.R. Rep. No. 85, 73d Cong., 1st Sess. 9 (1933).

29, para. 30).[6] Moreover, the notes were not rated "prime," even though most commercial paper has that rating (*id.* at 30, para. 37).[7]

In light of these unusual factors, the reasoning of the court of appeals in this case will not necessarily apply to other cases involving charges of negligence under Section 12(2). Other courts will undoubtedly recognize that the decision in this case "depends upon the circumstances" presented on the record (Pet. App. 13).

2. Nuveen also argues (Pet. 8-17) that certiorari should be granted to clarify the differences between the standards of care prescribed in Sections 12(2) and 11 of the Securities Act. Section 11 of the Act, 15 U.S.C. 77k, is a civil liability provision that applies only to registered offerings of securities and only to misrepresentations and omissions in a registration statement. In our view, this case is not an appropriate vehicle for clarifying the relationship between Sections 11 and 12(2). Even if, as a general matter, Sections 11 and 12(2) impose distinct standards of care, a standard of care that is the same or similar to that imposed by Section 11 may be appropriate in this unusual factual situation—involving an unregistered offering having many of the characteristics normally associated with an offering required to be registered.[8] In these circumstances, the standard of

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[6]Commercial paper ordinarily is marketed to institutional investors. See generally Board of Governors of the Federal Reserve System, *Statement Regarding Petitions to Initiate Enforcement Action* 1-2 (Sept. 26, 1980); Hurley, *The Commercial Paper Market*, 63 Fed. Res. Bull. 525 (1977).

[7]As of July 30, 1971, only 20 out of 635 commercial paper issuers rated by the National Credit Office were given quality ratings of less than "prime." That rating service later began to list only prime quality commercial paper issuers.

[8]Indeed, the district court concluded that registration was required in this case. See page 4, *supra*.

"reasonable care" under Section 12(2) may converge with the standard of "reasonable investigation" prescribed under Section 11.

In any event, the issue raised by petitioner Nuveen is not properly presented in this case. Nuveen argues (Pet. 9) that the court of appeals held that "the 'reasonable care' defense in Section 12(2) * * * creates the same duties for a seller of securities as the 'reasonable investigation' defense in Section 11 creates for an underwriter * * *." In fact, however, the court of appeals explicitly declined to adopt such a principle (Pet. App. 13):

> Since what constitutes reasonable care under §12(2) depends upon the circumstances, we, of course, do not intimate that the duty of a seller under §12(2) is always the same as that of an underwriter in a registration offering under §11.

Nuveen also argues (Pet. 13) that the standard imposed by the court of appeals in this case is even more stringent than that imposed under Section 11 because the court purportedly imposed a duty to "investigate the accountants' workpapers * * *." Nuveen suggests that, to satisfy the court of appeals' standard, an underwriter would be " 'under a duty to retain his own auditor to re-examine the books of [the] company * * *' " (Pet. 13-14, quoting *Levine* v. *SEC*, 436 F. 2d 88, 90 (2d Cir. 1971)). In the decision below, however, the court of appeals did not impose such a duty. Instead, it relied on (Pet. App. 5) an earlier decision in this litigation, which stated that examination of accountant's workpapers was but one of three sources of information, "any one of [which] * * * would have revealed deficiencies that would have mandated further inquiry" (Pet. App. 69).

3. Nuveen also argues (Pet. 18-26) that the court of appeals erred in imposing liability in this case because not

all of the investors in the plaintiff class were proven to have received a misleading prospectus distributed by it.

While the court of appeals stated that each plaintiff must prove "some causal connection between the misleading representation or omission and plaintiff's purchase" (Pet. App. 7), it found no requirement that each class member prove that he or she received a misleading prospectus. The court observed (Pet. App. 8; footnote omitted):

> Although the statute explicitly requires privity between plaintiff-purchaser and defendant-seller, its terms do not require that the particular sale to an individual plaintiff be directly by means of the prospectus alleged to be misleading.

Turning to the legislative history, the court noted that Congress recognized that false statements made during the distribution of securities could cause harm to individual investors even though the statements " 'may never actually have been seen by the prospective purchaser * * *' " (Pet. App. 8, quoting H.R. Rep. No. 85, 73d Cong., 1st Sess. 10 (1933)). In this case, Nuveen's publication of false reports contributed to the conditions that facilitated sale of the notes—and, conversely, "publication of WH's true financial condition would have caused a total collapse of the market for its notes" (Pet. App. 9).

Nuveen argues that the court misperceived the meaning of the statute and the legislative history and that only those plaintiffs who actually received a misleading prospectus or oral communication can recover under Section 12(2) (Pet. 18-19). While Nuveen's argument is not insubstantial, review of that claim by this Court is not necessary at this time. The narrow legal question whether investors may recover under Section 12(2) based on material misrepresentations and omissions that foster conditions necessary for the sale of securities has not been a recurring one in the

federal courts.[9] Indeed, it appears to be a question of first impression under Section 12(2).[10] Should a conflict among the circuits develop on this issue at a later time, review by this Court may then be appropriate.[11]

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[9]The question whether plaintiffs under Section 12(2) must prove "reliance" on a misleading prospectus or oral communication has been addressed. The courts of appeals that have addressed the question unanimously have held that reliance need not be proved. See *Wigand* v. *Flo-Tek, Inc.*, 609 F. 2d 1028, 1034 (2d Cir. 1979); *Alton Box Board Co.* v. *Goldman, Sachs & Co.*, 560 F. 2d 916, 924 & n.12 (8th Cir. 1977); *Hill York Corp.* v. *American International Franchises, Inc.*, 448 F. 2d 680, 695 (5th Cir. 1971); *Gilbert* v. *Nixon*, 429 F. 2d 348, 356-357 (10th Cir. 1970); *Johns Hopkins Univ.* v. *Hutton*, 422 F. 2d 1124, 1129 (4th Cir. 1970), cert. denied, 416 U.S. 916 (1974); *Demarco* v. *Edens*, 390 F. 2d 836, 841 (2d Cir. 1968); *Woodward* v. *Wright*, 266 F. 2d 108, 116 (10th Cir. 1959).

[10]Nuveen urges (Pet. 23-24) that the decision below conflicts with this Court's decision in *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 728 (1975), and with the Second Circuit's decision in *Jackson* v. *Oppenheim*, 533 F. 2d 826 (1976). *Blue Chip Stamps*, however, involved no issue under Section 12(2). And *Jackson*, as the court of appeals pointed out (Pet. App. 9 n.7), involved a communication that was not part of an effort to sell securities.

Nuveen also argues (Pet. 24-26) that certiorari should be granted because the decision of the court of appeals may result in liability for persons not in privity with the purchaser. This case is hardly an appropriate vehicle for addressing that question, however, since all of the respondents were in privity with Nuveen.

[11]Other factors suggest that this case is a poor candidate for further review. After a decade of litigation, the 42 class members in this case have received a judgment of approximately $500,000. To reach that result, the parties have gone through a trial and supplemental trial in the district court, have briefed this case in the Seventh Circuit on four separate occasions, and also have obtained review in this Court (see note 3, *supra*). If this Court were to reverse the court of appeals' judgment on the ground that each class member must prove actual receipt of a prospectus, the respondents still would have several alternative grounds for seeking affirmance of the judgment in their favor (see Pet. App. 6 n.3). As previously noted (page 4, *supra*), they obtained a judgment in the district court based on Section 12(1), and the court of appeals did not disturb that ruling. In addition, respondents contend

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

WADE H. MCCREE, JR.
Solicitor General

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JANUARY 1981

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that each class member received misleading *oral* communications, a question on which the court of appeals reserved judgment and which may require further proceedings in the district court. Moreover, several courts have sustained Section 12(2) liability on the basis of implied misrepresentations in cases similar to this, and the court of appeals also reserved judgment on that issue. Thus, a decision by this Court on the issue presented in the petition would not terminate "this protracted litigation" (Pet. App. 59), but rather would only open the door for renewed controversy on these alternative grounds for affirmance.